National Reserve Bank of Tonga

Monetary Policy Statement

September 2012

NATIONAL RESERVE BANK OF TONGA

Monetary Policy Statement
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Monetary Policy Review

The Reserve Bank's monetary policy remained accommodative over the past six months. The Bank's outlook was for inflation to remain below 6 per cent and for foreign reserves to remain above three months of imports.

Gross Official Foreign Reserves reached a record high of $253 million in August, or 8.2 months of imports. Receipt of aid from Tonga's development partners underpinned this increase. Tongan consumer prices fell by 0.6 per cent over the year ended August 2012, a softer outcome than that recorded in the last Monetary Policy Statement. As such, the Reserve Bank's primary objectives of maintaining an adequate level of foreign reserves and promoting low and stable inflation were achieved.

Global economic growth slowed during the second quarter of 2012, after rebounding in the first quarter. The slowdown was broadly based because spillovers from financial stress in the Euro Area periphery were widespread and domestic factors caused a slowdown in Asia. As such, the IMF has softened its global growth forecasts since March, now projecting real GDP to grow by 3.3 per cent and 3.6 per cent over the 2012 and 2013 calendar years.

Tonga's real GDP is estimated to have contracted by 0.2 per cent over 2011/12, which is weaker than the outcomes of the past couple of years. The growth compares poorly with GDP growth globally, and throughout the South Pacific, for the same period.

Partly driving the weaker outcome was an accelerated decline in the value of remittances. A more disciplined Government budget also contributed, with the Government implementing a smaller budget deficit than in 2010/11. Activity in the construction sector fell significantly, with several large donor-funded projects coming to completion. The primary sector suffered from a depletion of sea cucumber and sandalwood stocks.

While the Reserve Bank has allowed a buildup of exceptional levels of liquidity to support domestic lending, this measure has been outweighed by other forces that have been reducing banks' appetite to lend. Notably, the continuing decline in remittances has contributed to the high frequency of borrower defaults over recent years, to which the banks have responded by tightening lending standards. The weak economic conditions and bleak outlook also affects demand for credit and potential investments.

The Reserve Bank has recently announced the removal of interest payments on banks' Exchange Settlement Accounts (ESAs). The idea is to strengthen banks' individual incentives to use these account balances for prudent private sector lending.

Monetary Policy Indicators

	Jun 2011	**Sep 2011**	**Dec 2011**	**Mar 2012**	**Jun 2012**	**Aug 2012**
Foreign Reserves ($TOP millions)	203.8	208.1	226.0	239.2	246.1	252.7
Foreign Reserves (months of import cover)	7.7	7.8	8.2	8.2	8.2	8.2
Nominal effective exchange rate	104.1	106.7	105.1	104.7	103.3	103.4
Weighted average term deposit rate (%)*	3.3	3.2	3.2	3.5	3.4	3.5
Weighted average lending rate (%)*	11.3	11.2	11.2	10.9	10.9	10.7
Consumer price inflation (annual, %)	7.2	5.6	3.8	1.8	2.5	-0.6
Domestic items	2.7	2.2	1.0	0.4	5.8	-1.2
Imported items	10.7	8.0	5.9	2.8	0.2	-0.1
Private sector credit growth (annual, %)	-7.6	-8.4	-10.8	-12.6	-9.7	-8.5

*The banks changed their reporting methodology in January 2012, which has made the series more volatile than previously.
Source: NRBT; Statistics Department

Outlook

The Ministry of Finance has forecast Tongan real GDP growth of 0.4 per cent for the 2013 financial year. The outcome is better than for 2012 but below the average of the past decade. The Reserve Bank anticipates a similar outcome, with the outlook for remittances still bleak and a more disciplined government budget providing less short-term support to growth. The recent downward revision of global economic growth prospects will have spillover effects on Tonga through remittances, tourism, currency movements, oil and food prices. .

Construction activity is expected to contract the most, following the completion of large donor-funded works. The outlook for tourism is also modest. Any significant growth will depend on either a reversal of recent declines in visitor numbers, or a rise in real spending per visitor, which is already high by historical standards. The primary sector has mixed prospects. The depletion of Tonga's sea cucumber and sandalwood stocks point to slower long-term growth but may be offset by rising demand for other agricultural goods, like watermelon and squash.

Credit outcomes are likely to remain soft in the next six months, albeit perhaps not so soft as over the past year. A high level of liquidity and the Reserve Bank's recent removal of interest payments on the ESA balances are both designed to support lending growth.

The level of foreign exchange reserves is expected to increase in the next six months, due to the expected receipt of official aid funds. Foreign reserves are then expected to start declining towards the end of 2013, with the commencement of China loan repayments in September 2013. Nevertheless, foreign exchange reserves are expected to remain comfortably above three months of import cover.

Inflation is expected to remain below the Reserve Bank's benchmark of 6 to 8 per cent in the next six months. Despite generally falling over the six months to August, world oil prices have picked up over the past few months, mainly due to supply disruptions amidst growing unrest in the Middle East. The Pa'anga has been relatively steady against the US dollar in that time so most of the recent oil price increases will be reflected in higher imported fuel prices. However, with modest prospects for Tonga's domestic economic activity, and the second round effects of lower imported inflation still to play out, the outlook for domestic inflation is to remain low over the next six months.

Against this background, the current accommodative monetary policy stance will be maintained in the next six months. The Reserve Bank will continue to target maintaining the country's foreign reserves position at an adequate level, and promoting low inflation, mindful of the risks to the global economic outlook. The Reserve Bank will continue to monitor closely the country's economic and financial conditions in order to promote a sound and efficient financial system.

Siosi C. Mafi
Governor

1. International Economic Developments

Major Economies

After rebounding in the first quarter, global growth slowed during the second quarter of 2012. The slowdown was broadly based because spillovers from financial stress in the Euro Area periphery were widespread. Domestic factors also caused a slowdown in Asia. As such, the IMF has revised down its global growth forecasts since March, now projecting real GDP to grow by 3.3 per cent and 3.6 per cent over the 2012 and 2013 calendar years (In April it was forecasting 3.5 per cent and 4 per cent growth).

In Europe real GDP fell by 0.25 per cent over the first half of 2012. Monetary policy was accommodative, but the overall fiscal policy stance was contractionary and outcomes for investment and consumption in the Euro area were poor. Financial conditions have generally worsened over the past six months and, accordingly, the outlook for growth in the region has weakened. The economy is expected to contract by 0.4 per cent in calendar 2012, followed by growth of 0.2 per cent over 2013.

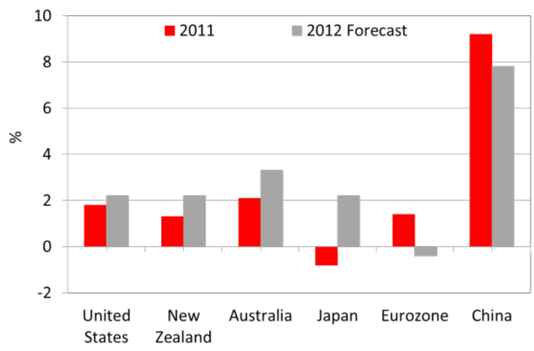
The momentum of the US economic recovery slowed over the first half of 2012, with growth in employment, investment, and consumption declining. Largely responsible were spillovers from Europe and uncertainty relating to the possibility of a much tighter fiscal policy in 2013. As the problems in Europe have escalated the US is now expected to grow by around 2 per cent in both 2012 and 2013.

Chinese real GDP growth slowed in the first half of 2012, partly in response to a tightening in monetary policy in 2010 and 2011. However, with inflation and house price growth having since eased, the Chinese authorities have unwound some of the policy tightening and a pick-up in growth is anticipated from late this year. Still, a return to 10 per cent growth seems unlikely in the near term.

In Japan, growth over the past six months was bolstered by reconstruction activity, repairing the damage caused by the March 2011 earthquake and tsunami. Growth is expected to remain firm in the near term, owing to ongoing support from the construction sector and a rebound in manufacturing activity following recent supply disruptions. These factors are expected to fade in 2013 though, and growth of around 1.2 per cent is expected at that time.

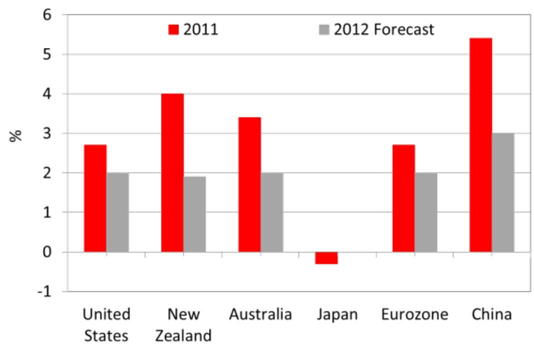
In Australia, real GDP grew by 1.3 per cent over the first half of 2012. As has been the case for some time, mining activity and related investment were the primary drivers. The unemployment rate remains low, though softer labor market conditions are being disguised by a fall in hours worked and labor force participation. Events in Europe are weighing on the growth outlook, but the central bank has room to reduce interest rates, despite having already reduced rates by 75 basis points between end March and end September.

Real GDP Growth in Major Economies



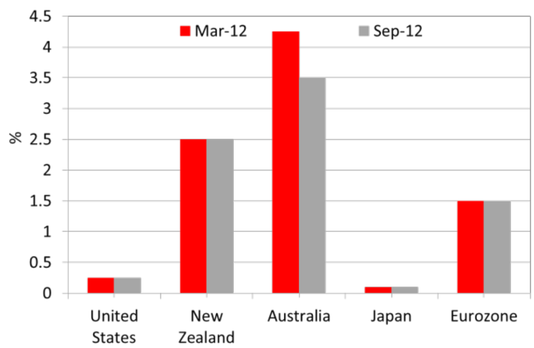
Source: IMF World Economic Outlook - October 2012

Inflation in Major Economies



Source: IMF World Economic Outlook - October 2012

Interest Rates in Major Economies



Source: Consensus Forecast September 2012

World Data

Per cent

	Real GDP growth			Inflation			Unemployment*			Interest rates	
	2011	2012f	2013f	2011	2012f	2013f	2011	2012f	2013f	90-dy	10-yr
Eurozone	1.4	-0.4	0.2	2.7	2.3	1.6	10.2	11.2	11.5	0.3**	1.6**
United States	1.8	2.2	2.1	3.1	2.0	1.8	8.9	8.2	8.1	0.1	1.8
China	9.2	7.8	8.2	5.4	3.0	3.0	4.1	4.1	4.1	6.6***	
Japan	-0.8	2.2	1.2	-0.3	0.0	-0.2	4.5	4.5	4.4	6.3	0.8
Australia	2.1	3.3	3.0	3.4	2.0	2.6	5.0	5.2	5.3	3.8	4.9
New Zealand	1.3	2.2	3.1	4.0	1.9	2.4	6.5	6.5	5.7	2.5	4.5

* As at December

** Euro rate in Germany

*** One-year base lending rate

Source: IMF World Economic Outlook, October 2012

Real GDP in New Zealand is estimated to have grown by 1.1 per cent over the first half of 2012. Despite extended stimulus from low interest rates the unemployment rate remains relatively high. Annual headline inflation is currently around 1 per cent, with lower food prices driving the soft outcome. Over the next few years real GDP is expected to grow at around 3 per cent, benefitting from reconstruction activity for the Canterbury region. Fiscal consolidation and modest trading partner growth are likely to be somewhat offsetting.

World oil prices (Brent crude) averaged US$112.9 per barrel in September 2012, compared with US$124.5 in March 2012. The fall was underpinned by higher production by OPEC and slowing demand in the US, Europe, and China. Sanctions were imposed on Iranian oil production in July, but had limited effect on global supply.

On a trade-weighted basis, the nominal effective exchange rate depreciated by 1.5 percent over the six months to September 2012, and by 3.3 per cent over the year (the bilateral exchange rates are illustrated in Appendix 1). The Real Effective Exchange Rate (REER) depreciated by 1.3 percent over the year to June (the latest for which data are available), as inflation was lower in Tonga than in its trading partners.

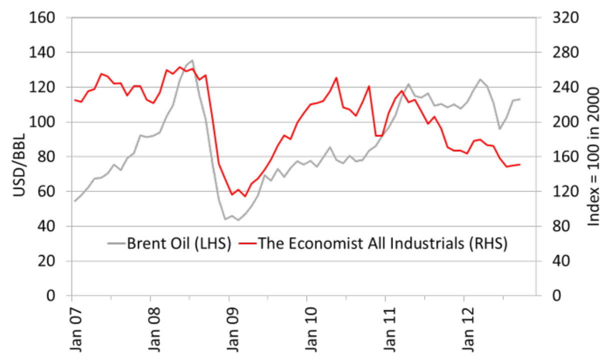
Pacific Economies

The most recent data for the Pacific suggest that Papua New Guinea and the Solomon islands recorded the fastest rates of real GDP growth over 2011. The two countries have been outperforming their peer group for some time, with construction activity for a Liquid Natural Gas project driving growth in Papua New Guinea, and a pick-up in log and copra production driving growth in the Solomons. As is true for most of the South Pacific, growth is expected to slow soon; investment in Papua New Guinea's Natural Gas project has peaked, and growth in the Solomon's logging industry is expected to decelerate.

In Fiji, real GDP growth was around 2 per cent in 2011. Sugarcane production grew particularly strongly, though a recovery from cyclone damage caused many other agricultural sectors to improve performance also. Growth for 2012 is projected to remain at around 2 per cent.

Inflation outcomes in the region have been mixed lately. Lower international food and fuel prices have contained inflation in some of the Pacific Island economies.

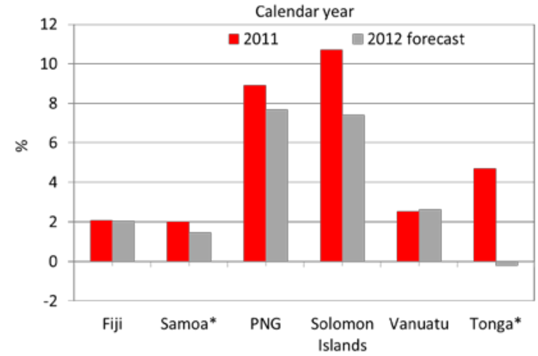
Commodity prices



Source: Consensus

Real GDP Growth in the Pacific

Calendar year



* Financial year

Source: IMF World Economic Outlook and Statistics Department

2. Review of the Tongan Economy

Growth in Tonga's Economy

Since the March *Monetary Policy Statement* the Statistics Department has released revised historical estimates of real GDP growth. The revisions incorporated donor-funded in-kind construction projects that have recently been completed in Tonga, and the activities of some major Tongan enterprises that were previously excluded. The changes have increased the rate of real GDP growth that has been recorded for recent years, particularly for the 2010 financial year, during which the level of in-kind construction activity was high.

In its 2012/13 Budget Statement, the Ministry of Finance has estimated real GDP to have fallen over the 2012 financial year, by 0.2 per cent. Developments were mixed:

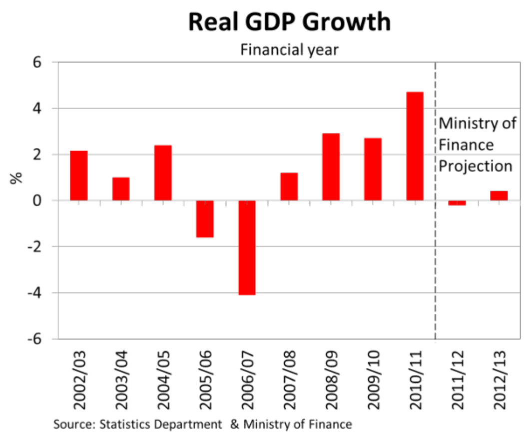
- Consumption tax receipts grew by 30 per cent, perhaps reflecting more of the improvement in tax collection, than an increase in actual household consumption. Moreover, remittances and household credit fell by 23 per cent and 1.5 per cent respectively, so strong growth in consumption is unlikely. Vehicle and container registrations data provided conflicting signals, as container registrations fell and vehicle registrations rose sharply.

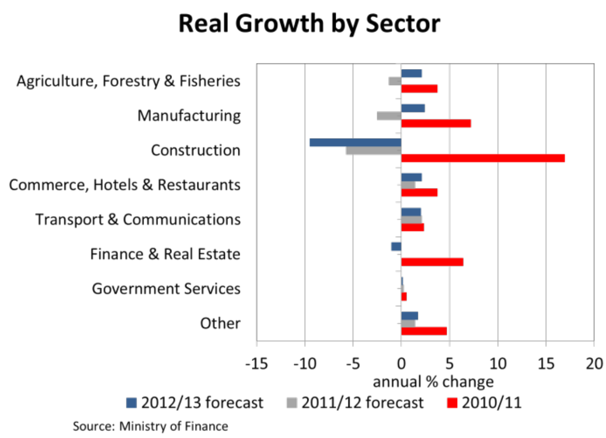
- Being constrained by its high debt levels, the Government implemented a budget deficit that was smaller than in 2010/11, by $33.6 million. The budget therefore provided less short-term support to economic growth.

By sector, construction looks like having contracted most sharply, at an estimated 5.5 per cent. The construction sector accounts for around 10 per cent of GDP, so would have subtracted around 0.5 percentage points of GDP growth over the financial year. The slowdown in the sector owes to the recent completion of large donor-funded projects, such as the Vaiola Hospital and the CBD reconstruction.

The primary sector (agriculture, forestry and fisheries) accounts for around 17 per cent of GDP, and was also estimated to have contracted over the 2012 financial year. Most of the output of this sector is not captured by official data, but in terms of the output that is exported, the banks' overseas exchange transactions show lower proceeds for the financial year. Export proceeds from sandalwood and sea cucumber fell the most, by 69 per cent and 85 per cent, because of overharvesting in previous years. Agricultural exports have fallen further since June, with zero recorded for sea cucumber.

For sectors exposed directly to tourism, total visitor arrivals fell by 5.8 per cent in 2011/12, owing to a contraction in the number of cruise ship arrivals. However, cruise ship arrivals tend to stay in Tonga for only short periods of time so their impact on tourism earnings is less significant than air arrivals, which fell by around 1 per cent. More recently the number of total visitor arrivals has fallen further, though falls are common at this time of year.





The slowdown in visitor arrivals has been partly offset by a marked pick-up in estimated average real spending per visitor over the past year. The rise is particularly evident after June 2012, possibly because of the Royal Wedding and the Liahona School reunion in July. That said, all card transactions in Tonga are recorded as travel receipts, and remittances can be made via card transactions, so misclassification may be causing some of the rise as well.

Outlook

The Ministry of Finance has forecast growth for Tonga of 0.4 per cent for 2012/13. The outcome is better than the 0.2 per cent contraction in the previous year, but below the average growth over the past decade. The Reserve Bank anticipates a similar outcome, with a number of indicators pointing to slow growth over the coming year.

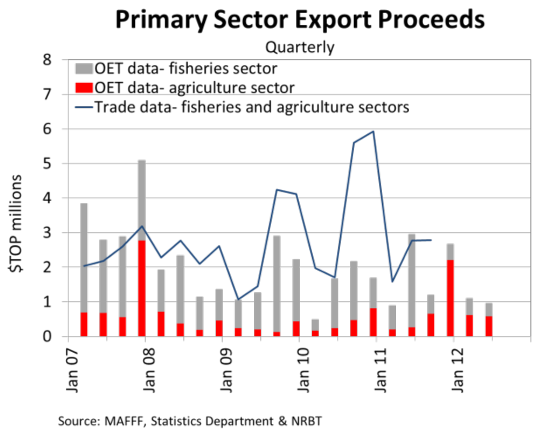
Above all, with the global growth outlook deteriorating over the past six months, prospects for remittances have worsened and further declines are expected.

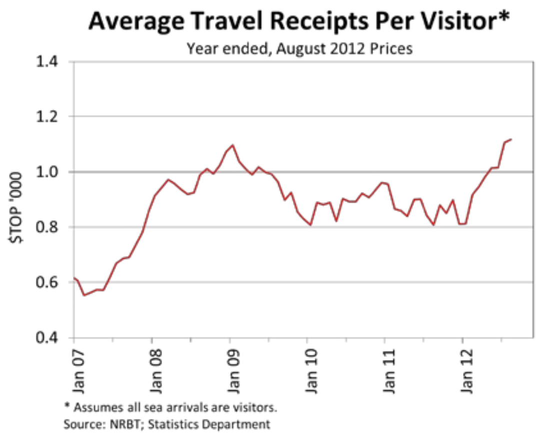
The Government again implemented a more disciplined budget, which will provide less short-term support to growth unless some of the intended productivity improvements materialize quickly. For example, the establishment of an agricultural marketing fund, providing up-front payment to growers before their produce is exported, might improve productivity and market access. A modest pick-up in credit outcomes, as discussed in the next chapter, might also help to support economic growth.

Construction activity is expected to slow further, by 9.5 per cent, as large donor-funded works are completed. A number of new donor-funded projects are scheduled for the year, but are not as large in comparison. The number of new building approvals for non-civil works has picked up recently, albeit not enough to suggest that material growth in this sector is likely soon.

The outlook for the agriculture and fisheries sector is mixed. While sea cucumber exports might generate limited proceeds in the near term, the longer term outlook is bleak, with Tonga currently risking the full depletion of its sea cucumber stock. The stock of sandalwood will also take some years to replenish, and export earnings are likely to be low for some time. Growth in Tonga's trading partners may generate some pick-up in other agricultural sectors, though local productivity enhancements will be necessary for sustained improvements in future.

The outlook for tourism in the next six months is also soft. Any significant growth depends largely on a reversal of recent declines in visitor numbers, which has become less likely with the downward revisions to the global growth outlook. A pick up in cruise ship arrivals, resulting from the construction of the new wharf, may contribute somewhat in the longer term. A rise in real spending per visitor could provide an alternative source of growth for the sector, but that already seems high by the standards of the past few years, with a few one-off events taking place in July.





3. Review of Monetary Conditions

Liquidity

Liquidity in the banking system rose to $124.4 million at the end of August 2012, from $110.2 million at the end of February 2012. The rise owed to a pick in in foreign reserves, which the NRBT chose not to offset with any issue of NRBT notes. At over 15 per cent of nominal GDP, the level of liquidity is high. It is intended to support a pick-up in lending and more positive economic outcomes.

Private Sector Credit Growth

Total private sector credit fell by 8.5 per cent over the year ended August, compared with a 12.5 per cent fall over the year ended February. Most of the recent fall was driven by a 17 per cent decline in business lending. Household credit also fell though, by 1.5 per cent.

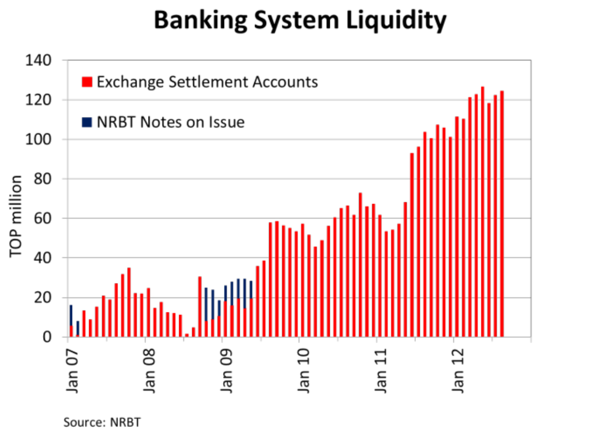
The on-lent amount of loans from the Export-Import Bank of China has been unchanged for over 12 months now, thus having no further effect on the level changes in credit. However, lending by the South Pacific Business Development Fund and the Retirement Fund Board increased, and incorporating those balances into credit generates a more positive picture of domestic lending. Total credit would have fallen by 6 percent over the year ended August, and household credit would have grown by 2.3 per cent.

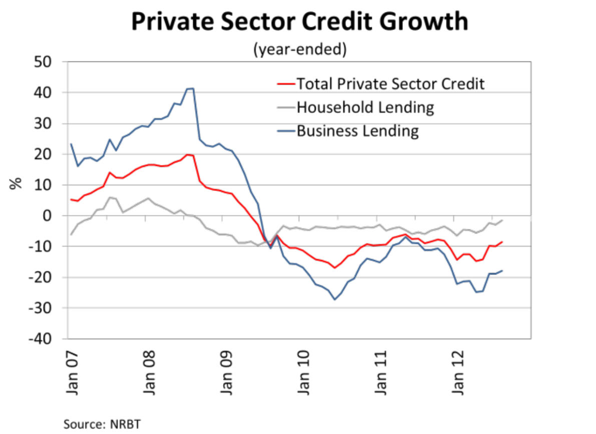
While the exceptional levels of liquidity are intended to support domestic lending, they have been insufficient to outweigh other forces that have been reducing banks' appetite to lend. Notably, the continuing declines in remittances have contributed to a high frequency of borrower defaults over recent years and banks have responded by tightening their lending conditions. At the same time, the weak economic conditions and bleak outlook affect demand for credit and potential investments. The Reserve Bank has recently announced the removal of interest payments on banks' ESAs to strengthen banks' individual incentives to use these accounts for prudent private sector lending.

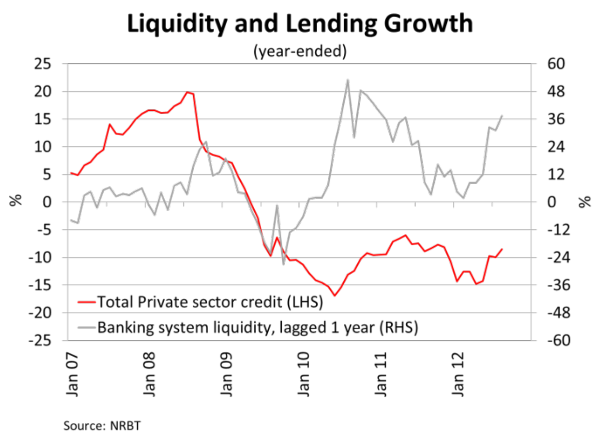
At the end of August 2012, lending to the household sector accounted for 55 per cent of the total private sector credit, and lending to the business sector accounted for 45 percent. Household lending was directed mostly to housing.

Interest Rates

In order to improve the quality of data received from banks, the Reserve Bank introduced a new set of reporting forms in January 2012. The new data reported for interest rates on deposits and loans have been more volatile than previously. Looking through the volatility, deposit rates have risen slightly over the past six months, while lending rates have been mixed.





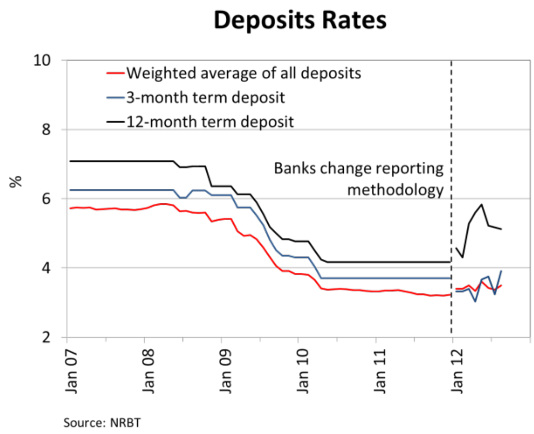


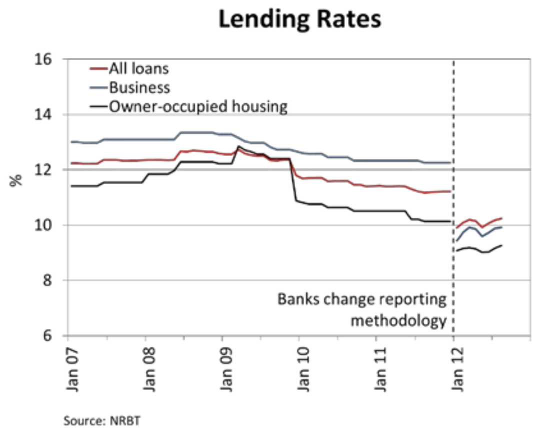
The 3-month term deposit rate rose by 60 basis points over the six months to August 2012, and the 12-month rate rose by 80 basis points. At the same time, the weighted average interest rates on saving deposits increased by around 10 basis points.

The lending indicator rate, a weighted average of interest rates across household and business lending, rose by 15 basis points over the six months to August, to 10.24 per cent. The average rates for business lending increased by 20 basis points to 9.9 per cent, and for housing increased by 10 basis points to 9.3 per cent. The analysis of the data from the new set of returns should be more meaningful as the new time series builds up.

Outlook

Exceptionally high levels of liquidity and the removal of interest payments on banks Exchange Settlement Account balances are both designed to support a pick-up in lending outcomes in Tonga. However, other factors are likely to weigh on borrowers' ability to service loans, including continuing falls in the level of remittances and a modest short-term outlook for domestically generated income, as discussed in Chapter 2. Overall, credit outcomes are likely to remain quite weak in the near term, albeit perhaps not so weak as over the past year.





4. Maintain Adequate Foreign Reserves

Official Foreign Reserves

Gross Official Foreign Reserves increased by 10 per cent over the six months to August 2012, reaching a record high of $252.7 million. This is equivalent to 8.2 months of imports. The increase was due mainly to the receipt of foreign aid from Tonga's development partners, which more than offset official loan repayments and imports.

Foreign Exchange Payments

Year-ended foreign exchange payments, as measured through the banks' Overseas Exchange Transactions (OET), fell by 12 per cent over the six months to August 2012, to $345 million. The fall was attributed mainly to lower capital outflows and merchandise import payments.

Year-ended merchandise import payments fell by 8 per cent over the six months to August, consistent with the slowdown in domestic demand. Most other categories of imports also recorded falls. Over the past six months the import of construction materials declined sharply, reflecting the recent completion of major construction projects in the Kingdom.

Foreign Exchange Receipts

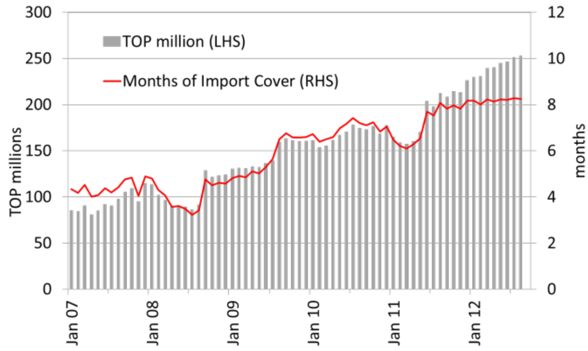
Year-ended OET receipts fell by 20 per cent over the six months to August. Lower remittances, exports and capital inflows offset a rise in tourism receipts.

Annual remittances fell by 14 per cent over the six month period. The historical peak of annual remittances occurred in March 2008, when remittances were $214 million, or 27 per cent of Tonga's GDP. Over the year ended August 2012 remittances were $108.7 million, or less than 14 per cent of GDP. The fall represents a significant decline in the disposable income of Tongans, and explains much of the weakness in Tonga's economy.

To a large extent the fall in remittances has been caused by a deterioration in employment and income growth in the US, New Zealand and Australia. These are Tonga's key sources of remittance flows, with information from Tonga's foreign exchange dealers suggesting that Australia is the largest source, followed by New Zealand. (Using the banks' OET data alone, it was previously understood that remittances from the US were the largest share.)

The seasonal workers program, whereby local Tongan's are provided fruit picking employment in Australia and New Zealand, is providing offsetting albeit limited support to remittances growth. The latest estimates show that remittances from these programs accounted for less than 5 per cent of total remittances over January to August 2012.

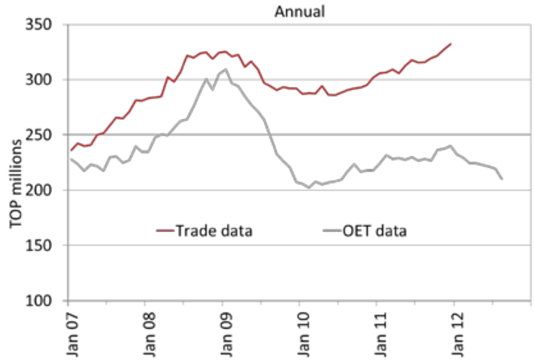
Official Foreign Reserves



Source: NRBT

Import Payments

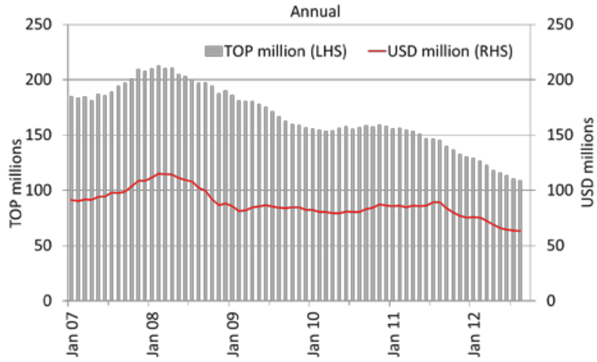
Annual



Source: Statistics Department & NRBT

Remittances

Annual



Source: NRBT

As discussed in Chapter 2, some remittances might be mistakenly classified as travel receipts, thus understating the amount of remittances growth over recent years.

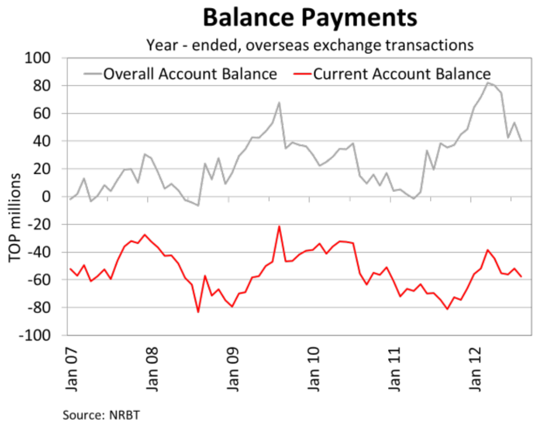
Year-ended merchandise export receipts fell over the six months to August 2012, by 33 per cent. The fall was due mainly to lower proceeds from marine exports.

Balance of Payments

The year-ended OET current account deficit widened to $57.6 million in the six months to August 2012, from $51.8 million in the previous six months, largely reflecting the lower private remittances and exports. The surplus in Tonga's capital account narrowed but was still large enough to offset the current account deficit. The overall balance was a surplus of $40 million over the year-ended August 2012, from a surplus of $71.8 million in the year ended February.

Outlook

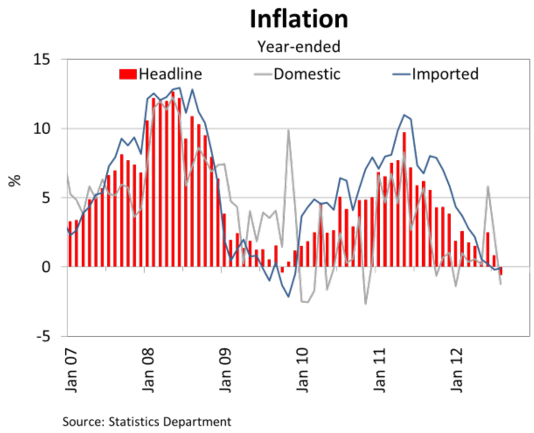
The level of foreign exchange reserves is expected to rise in the next six months, on the back of receipts of development partners' aid. It is then expected to fall towards the end of next year, mainly due to the commencement of the repayment of the China loan in September 2013. Nevertheless, foreign exchange reserves are expected to remain comfortably above three months of import cover.



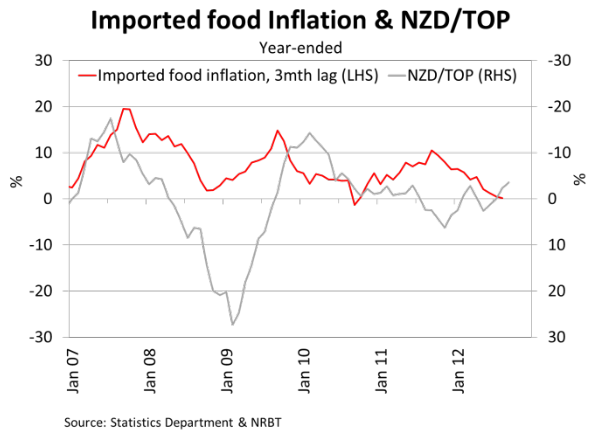
5. Promote Low and Stable Inflation

Inflation

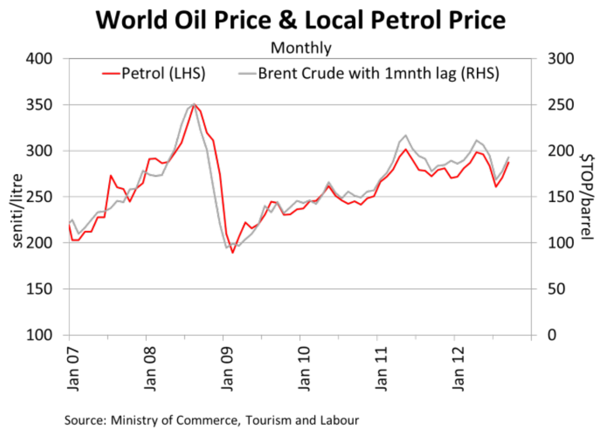
Tongan consumer prices fell by 0.6 per cent over the year ended August 2012, having slowed since the NRBT's previous *Monetary Policy Statement*. The decline owed mostly to falls in the prices of imported goods. Inflation on domestically produced goods was also slow by historical standards, despite showing some volatility in June.



Prices of imported goods fell by 0.1 per cent over the year ended August 2012. The outcome is the softest for several years, and compares with an increase of 2.8 percent over the year-ended March 2012. The fall in imported inflation was most evident in the prices of food, which Tonga imports mostly from New Zealand. Food prices in New Zealand fell by 0.9 per cent over the past year, and would have had a greater effect on Tonga's domestic food prices if not for a strengthening in the New Zealand dollar.



Another driver of the soft imported inflation outcome was falls in the prices of imported fuels; the private transport component of the CPI fell by 2.2 per cent over the 12 month period, after having risen by almost 15 per cent over the prior year. The recent fall owes to an overall decline in world oil prices, which flow through to the local prices of petrol and diesel with a 1 month lag. The Pa'anga depreciated against the US dollar over the year, which locally offset some of the fall in world oil prices.



Prices on the domestic items in the Consumer Price Index have fallen by 1.2 per cent over the past year. Domestic inflation is volatile but has been at low levels for about a year now. The most significant decline in prices was recorded for domestic food, with favorable harvesting conditions prevailing over the past year. Competition from lower imported food prices may have also caused local price declines.

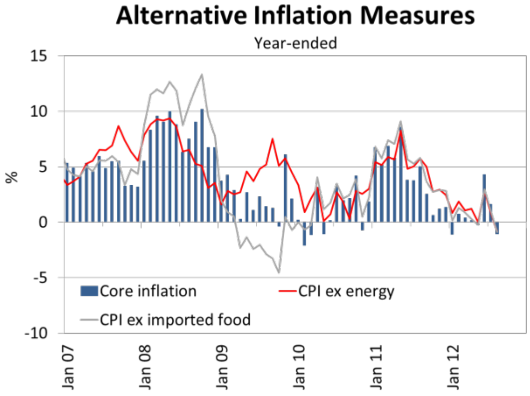
To some extent the falls in domestic inflation probably reflect the second round effects of lower imported inflation, which reduces the costs of producing local products. The fall may also owe to soft aggregate demand, with growth in domestic economic activity slowing markedly from 2010/11.

With recent falls in prices being so broadly based, unsurprisingly the rate of core inflation has also been slow by historical standards, at 1.1 per cent over the past year (core inflation excludes both food and energy prices).

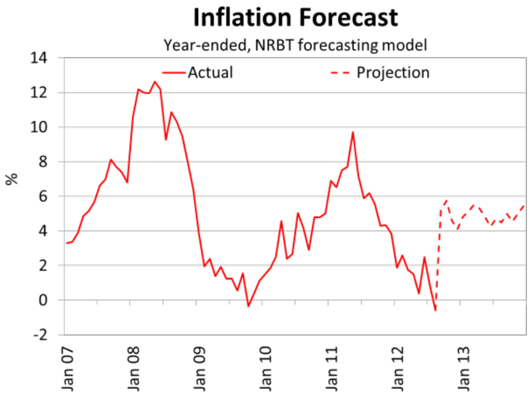
Outlook

To help predict inflation rates going forward, the Reserve Bank uses an inflation model that is based on variables such as Crude Oil prices and exchange rates. World oil prices have picked up over the past couple of months, mainly due to supply disruptions amidst growing unrest in the Middle East. The Pa'anga has been steady against the US dollar so most of the increases will be reflected in higher prices locally. Overall, the model suggests that year-ended inflation will return to around 5 per cent in six months, and remain thereabouts throughout 2013.

There are, however, a number of other factors that are likely to weigh on inflation during that time. Most notably, increased supply of domestically produced food items, the slowdown in domestic economic activity and the second round effects of recent falls in imported inflation are likely to weigh on domestic inflation for at least the next six months. The Bank's assessment is that inflation will probably be considerably lower than the inflation model forecast during that time.

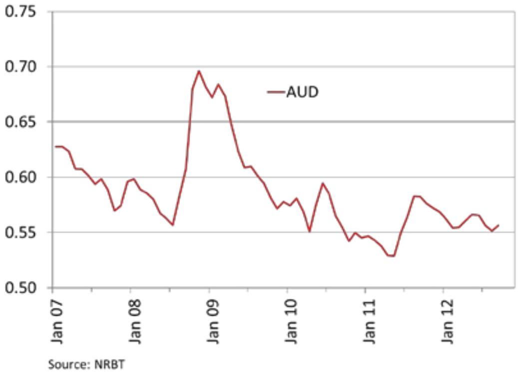


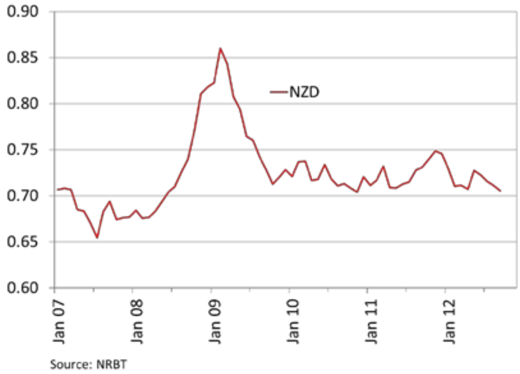
Source: Statistics Department & NRBT

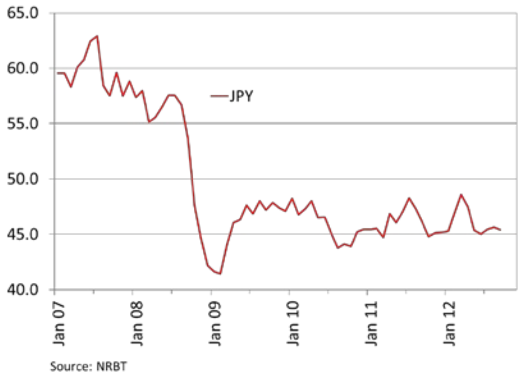


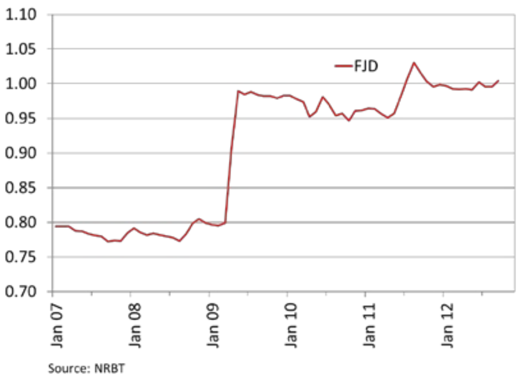
Source: Statistics Department & NRBT

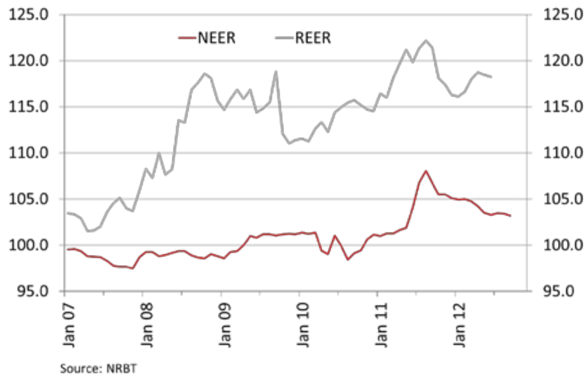
Appendix 1: Tongan Pa'anga Exchange Rates











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 2007, which state that the principal objectives of the Bank shall be to:

(a) maintain internal and external monetary stability; and

(b) promote a sound and efficient financial system;

Section 4 also states that the Reserve Bank will conduct its activities in a manner that supports macroeconomic stability and economic growth. In addition, Section 30 (2) of the Act gives the Reserve Bank the responsibility of maintaining an adequate level of foreign exchange reserves.

Under the Act, the Reserve Bank 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, which 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 economy and narrow export base, and its dependence on imports, it is imperative that foreign reserves are maintained at 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 as adequate.

Given the high component of imported goods in the CPI (58 percent), 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 mean that domestic prices are likely to move closely with the prices of traded goods, which in turn depends closely on the value of the exchange rate. Vulnerability to external shocks such as oil price increases, adverse weather conditions, 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 raising prosperity for Tonga.