

# Monthly Economic Review

## July 2014

Most of Tonga's major trading partners continue to exhibit robust economies. New Zealand's unemployment rate fell to a five-year low of 5.6 per cent over the June quarter, ahead of the national election on 20 September. Australia's solid economic growth outcome of 3.1 per cent in 2013-14 has not changed expectations of the next rate move being well into 2015. Despite headwinds, the US economy grew 2.5 per cent over the year to June, as consensus growth is revised back to above 2 per cent for 2014. However, the euro zone economy was stagnant in the June quarter prompting the European Central Bank to lower interest rates to 0.05 per cent.

The domestic economy continues to show signs of subdued growth, with mixed signals from key sectors. July's container registrations dropped, as conditions returned to business-as-usual following activity around preparations for national festivities. However, recent liaison with some major goods distributors suggests the sector is growing. Supporting solid trade activity is the total number of vehicle registrations which rose to its highest level since January 2007. The tourism sector was buoyed by the onset of the peak season with a 16.4 per cent increase in international air arrivals in July alone, up 0.8 per cent on one year ago. Following a strong June, domestic air traffic rose by 22.4 per cent in July, reflecting events in the outer islands. With the next cruise ship

not expected until October, liaison with handicrafts manufacturers suggests the sector is sustaining a period of very weak demand. Non-handicraft manufacturers have echoed a similar sentiment. Business activity proxy, electricity production, suggests soft activity in July.

Headline inflation continued to decline in July. In year-ended terms, prices rose by 1.9 per cent, down from 4.7 per cent in March. Easing inflationary pressures were largely due to declining domestic meat, fish & poultry prices. A strong supply of head cabbage and cucumber led to a dip in domestic fruit & vegetable prices. Imported components increased slightly over the month, due mainly to small increases in prices of meats and fruit & vegetables. Major contributor to recent imported inflation, the New Zealand dollar depreciated by 2.4 per cent relative to the pa'anga, over July, August.

The Nominal Effective Exchange Rate (NEER) index rose in July by 0.2 per cent, implying a slight appreciation of the pa'anga against its major trading partners. The Real Effective Exchange Rate (REER) dipped 0.1 per cent reflecting a rise in Tonga's international competitiveness. Over the year, both the NEER and REER index fell 2.4 per cent and 2.6 per cent, respectively.

Tonga's overall foreign exchange balance was in surplus in July, however, down from the June's surplus. This reflected a



moderate current account deficit and slight fall in capital account. The year-ended trade deficit widened to around T\$249.4 million in July. This was driven by a rise in import payments, particularly for oil, more than offsetting an increase in agricultural and marine export receipts. Remittances rose by 13.0 per cent, with increases from New Zealand and US sources, more than offsetting a decline from Australia. Low New Zealand unemployment figures and positive growth in the US may have contributed. Foreign reserves were T\$280.4 million, covering 9.0 months of imports, well above the NRBT's reference range.

Broad money fell by 1.2 per cent to \$364.6 million in July, down from 3 per cent in June. This reflects the rise in import payments as well as bank lending. Banking system liquidity rose by 2 per cent over the month, underpinned by a rise in foreign reserves. Gross loans-to-deposit ratio remains below the 80 per cent trigger level, indicating an adequate liquidity margin for prudent lending. Bank lending rose over the month, mainly due to households, particularly housing and vehicle loans. The increase in lending is due to a fall in lending rates, and consistent with a decline in non-performing loans. New commitments for households also increased, particularly for housing and vehicles. At the same time, deposit rates rose whilst lending rates continue to fall in July, producing the narrowest interest rate spread since at least February 2012. The lower lending rates reflect major banks' competition to retain performing customers through

refinancing, together with excess liquidity in the market.

Net credit to government declined in July 2014, therefore, contributing to the fall in broad money. This was mainly due to the issuance of government bonds to finance the concessional loan scheme announced in the 2014-15 Budget, and an increase in government revenue collection.

The NRBT remains cautiously optimistic that solid growth among Tonga's major trading partners, together with fair domestic conditions will continue the local recovery. While remain broadly positive, real sector conditions appear mixed in the wake of stimuli from various events and the onset of the tourist season. Inflationary pressures are stabilising as domestic agricultural production meets demand and prices of non-discretionary imports ease. Rising imports are natural given recent exchange rate developments and credit growth, and foreign reserves remain comfortably above the NRBT's benchmark. Credit conditions continue to improve and support a consumption-led recovery. Low inflationary and liquidity pressures together with ample foreign reserves provide no requirement to adjust monetary policy settings in the near-term.

