

# Monthly Economic Review

## May 2014

World growth is expected to accelerate in 2014 and 2015 reflecting improved conditions in most advanced economies. Conditions continue to strengthen in New Zealand, with demand placing upwards pressure on inflation and the exchange rate. Underpinned by planned fiscal consolidation and structural change, Australia's employment growth remains subdued. Despite recent downgrades, the US and euro zone are expected to continue recovering over 2014. Economic growth in China is expected to remain in line with its official growth target.

Developments in Tonga's real sector vary across key industries but broadly indicate slight improvement. The agricultural sector has sustained unfavourable weather conditions, while output from fisheries is expected to be soft. Construction activity is expanding, with latest data indicating a marked increase in public works approvals. Electricity production recorded a 5.6 per cent year-on-year increase in April, suggesting a more active economy. Partial indicators show strong growth among the distribution sector, as private container volumes increase steadily over the year to May. Liaison with tourism operators suggest the disruption caused by recent airline and cyclone-related challenges may be plateauing.

Growth in public administration has increased slightly over the 2013-14, partly reflecting a 5 per cent increase in wages.

Recent data suggests year-ended inflation may be tapering off from highs earlier in the year. However, inflation in May 2014 was 3.1 percentage points higher than at the same time last year in year-ended terms, driven by prices of imported and domestic goods. Most fresh produce imports are from New Zealand, where exchange rates have recently played a significant role in raising prices.

The Nominal Effective Exchange Rate (NEER) index fell by 0.1 per cent over May, implying a depreciation of the pa'anga against its major trading partners. The Real Effective Exchange Rate (REER) fell by 1.2 per cent by comparison. Over the year to May, both the NEER and REER index fell by 3.4 per cent and 2.5 per cent, respectively.

Over the year to May, Tonga's trade deficit narrowed to around T\$247.8 million. This was supported by a 28.8 per cent rise in export receipts, mainly due to agriculture and marine exports, while merchandise import payments declined only slightly. Merchandise imports accounted for 52.3 per cent of all payments whereas exports accounted for only 3.0 per cent of all receipts. Remittances rose by 2.9 per cent over the year contributing 48.7 per cent of total receipts in May.

Foreign reserves are currently around T\$266.8 million, covering 9.4 months of imports.

Over the year to May, broad money increased by 4.7 per cent, or 44 per cent of GDP. This was driven by a lift in net foreign assets (1.8 per cent) together with a rise in bank lending (10.9 per cent). Lending to households rose, more than offsetting a decline in lending to non-financial corporations. New commitments increased, driven by rises in both the household and business components, particularly those in the distribution sector. Deposit rates rose 9 basis points, while lending rates fell 89 basis points, producing the narrowest interest rate spread in at least 36 months. Liquidity fell by 4 per cent, due to an increase in import payments.

The draft Budget Statement for 2014-15, anticipates a deficit of T\$13.8 million, equivalent to around 1.6 per cent of GDP. The deficit reflects increased capital expenditure, which is expected to rise by more than 450 per cent from 2013-14. The deficit will be largely funded by grants and in-kind payments from development partners. The remainder will be financed through an 8.9 per cent increase in public debt, of which external debt accounts for more than 90 per cent.

The government will undertake the first domestic bond borrowings since January 2010, facilitated by the National Reserve Bank of Tonga (NRBT). Given the high Exchange Settlement Account balances, the issuance of government bonds would

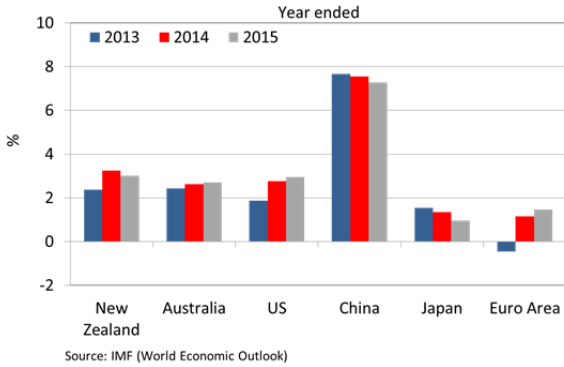
not have a material impact on banking sector liquidity.

Against the backdrop of a strengthening world economy, a partial recovery in Tonga's growth for 2013-14 can be expected. Indicators suggest there is stability in the domestic economy following an extended period of unsettled conditions. Robust growth is emerging in the construction and distribution sectors, and tourism weakness appears to be bottoming out. The exchange rate exhibits persistent weakness against major trading partners', encouraging a more favourable trade balance, despite some supply-side inflationary pressures. Foreign reserves remain dependably strong, affording more than 9 months' of imports. Bank customers are enjoying the narrowest interest rate spread in at least 2.5 years and increased competition in the sector. The 2014-15 Budget reveals plans to stimulate economic growth through capital investment, partially funded by an 8.9 per cent increase in public debt.

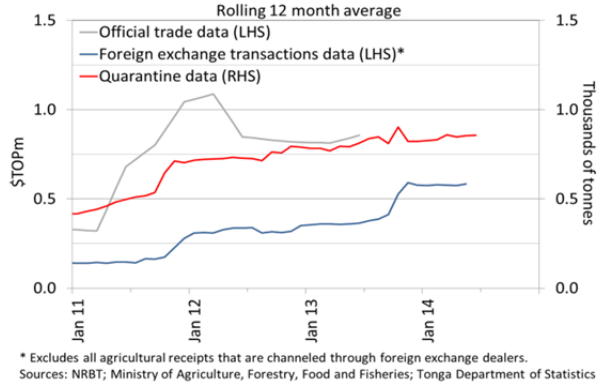
Despite persistently higher prices over recent months, drivers of domestic inflation reflect insufficient supply, not increased demand. Further, foreign reserves have consistently exceeded the upper reference range by at least two times since December 2011. Consistent with this, is the recommendation to maintain the existing monetary policy setting. However, it would be prudent to closely monitor developments of further inflation rises over the near-term.

# Attachment: Chart pack

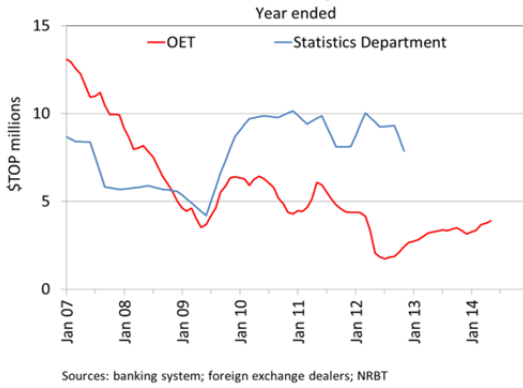
## Real GDP Growth Projections



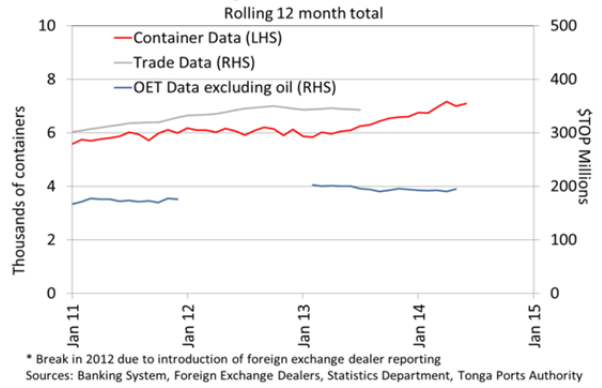
## Total Agricultural Exports



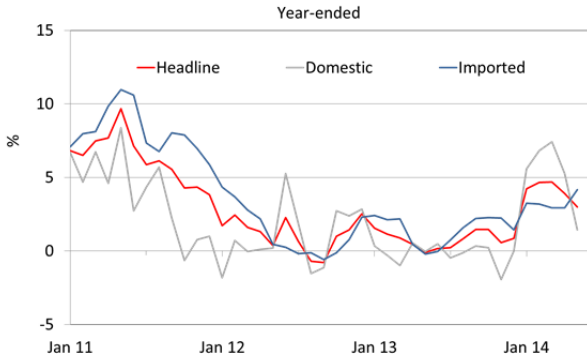
## Marine Exports



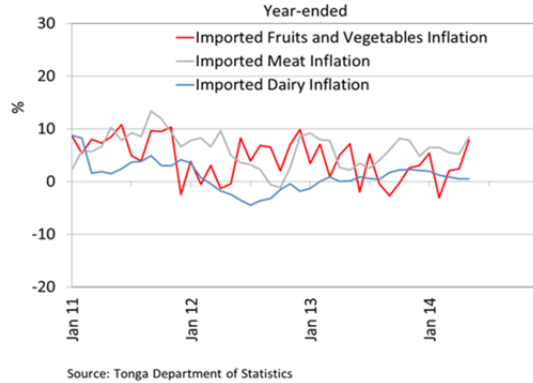
## Import Indicators

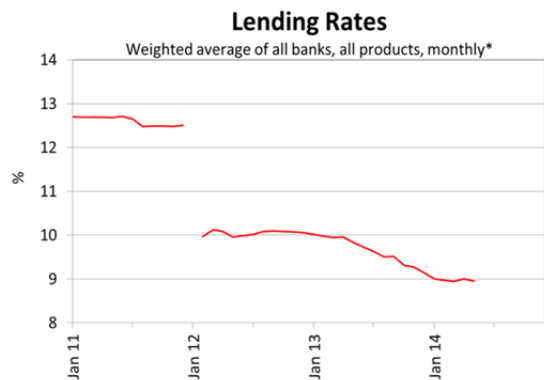
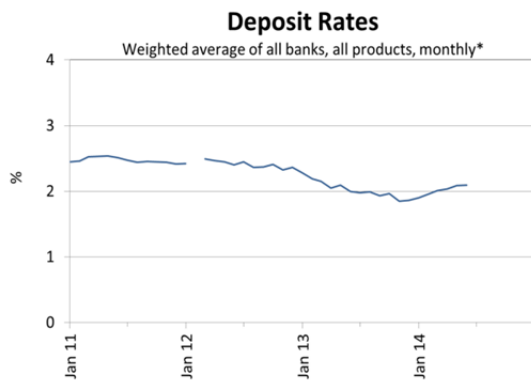
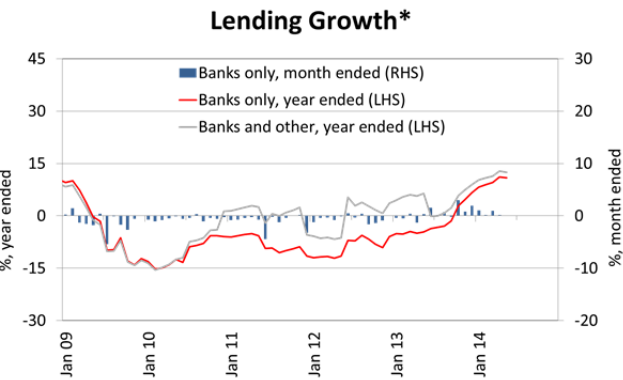
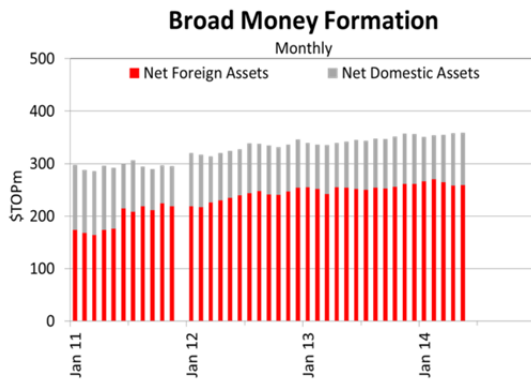
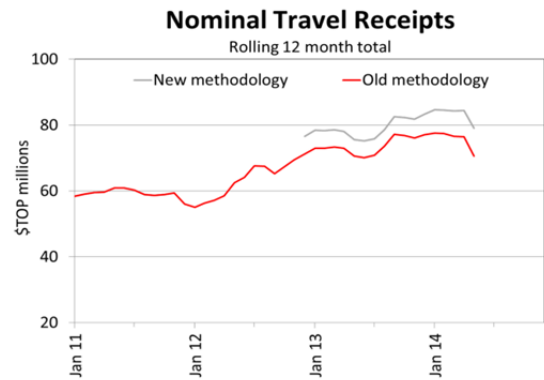
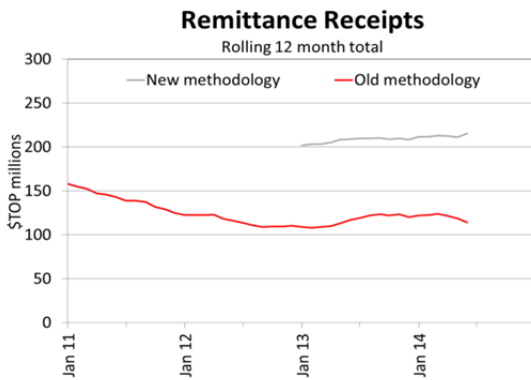
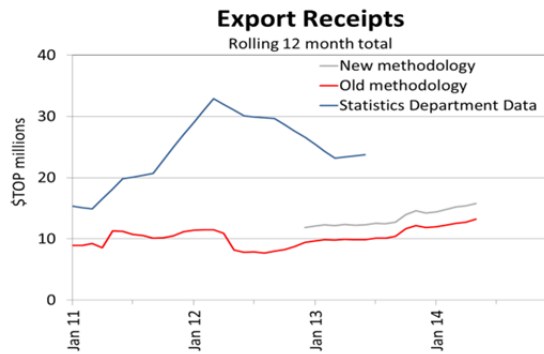
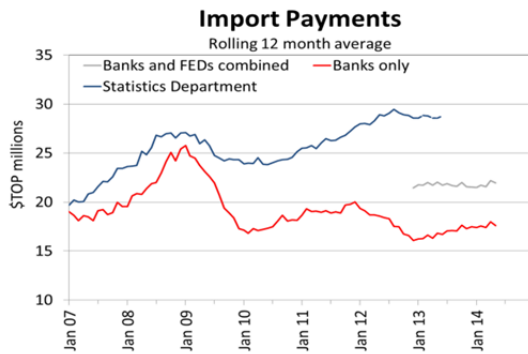


## Inflation



## Imported Food Inflation





### Government Draft Budget 2014-15

	Actual 2012/13	Revised estimates 2013/14	Estimate 2014/15	Jun-14 %YoY	Jun-15 % YoY	As % of GDP Jun-14	As % of GDP Jun-15
<b>Revenue</b>	<b>251.9</b>	<b>302.4</b>	<b>437.0</b>	<b>20.0</b>	<b>44.5</b>	36.5	51.1
Taxes & non-tax revenue	152.3	158.8	169.4	4.3	6.7	19.1	19.8
Grants	<b>99.6</b>	<b>143.6</b>	<b>267.6</b>	<b>44.2</b>	<b>86.4</b>	17.3	31.3
Current	52.7	116	116.2	120.1	0.2	14.0	13.6
Capital	46.9	27.6	151.4	-41.2	448.6	3.3	17.7
<b>Expenditure</b>	<b>259.6</b>	<b>293.7</b>	<b>450.7</b>	<b>13.1</b>	<b>53.5</b>	35.4	52.8
Current	<b>203</b>	<b>265.7</b>	<b>294.7</b>	<b>30.9</b>	<b>10.9</b>	32.0	34.5
Compensation of employees	94.9	105.4	121.8	11.1	15.6	12.7	14.3
Use of goods and services	76.1	119.8	122.7	57.4	2.4	14.4	14.4
Other	32	40.5	50.2	26.6	24.0	4.9	5.9
Capital	<b>56.6</b>	<b>28</b>	<b>156</b>	<b>-50.5</b>	<b>457.1</b>	3.4	18.3
Buildings & Structures	5.8	5.2	85.8	-10.3	1550.0	0.6	10.0
Machinery & equipment	34.1	18.3	48.3	-46.3	163.9	2.2	5.7
Other	16.7	4.5	21.9	-73.1	386.7	0.5	2.6
<b>Revenue - Expenditure</b>	<b>-7.7</b>	<b>8.7</b>	<b>-13.7</b>				

### Total Public Debt

Debt	Jun-14	Jun-15	Jun-15 % YoY	Jun-14 % of GDP	Jun-15 % of GDP
External	338.7	351.5	3.8	40.8	41.1
Domestic	29.5	49.5	67.8	3.6	5.8
<b>Total</b>	<b>368.2</b>	<b>401.0</b>	<b>8.9</b>	<b>44.4</b>	<b>46.9</b>