

Financial Markets Operation

Monetary Policy Formulation

The NRBT's monetary policy target is to maintain adequate level of foreign reserves above 3-4 months of import cover and to promote low and stable inflation below 6% annually. Throughout the 2014/15 financial year, the level of foreign reserves remained above seven months of import cover and headline inflation remained low. The NRBT monetary policy therefore remained accommodative throughout the year.

Domestic Market Operations

The Reserve Bank maintained its accommodative monetary policy stance remained unchanged during the financial year 2014/15 and the Reserve Bank therefore did not issue any Reserve Bank notes. This was to continue leaving excess liquidity in the system to encourage banks to lend and support economic growth.

As of the 30 June 2015, the banking system liquidity stood at \$169.5 million, an increase from \$149.9 million at the end of June 2014. The banking system liquidity comprised mainly of \$150.3 million in the banks' Exchange Settlement Accounts (ESA) held with the Reserve Bank and \$19.2 million of Government of Tonga's Bonds held by the banks. The higher liquidity was in line with the higher foreign reserves and government bonds held by the banks.

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

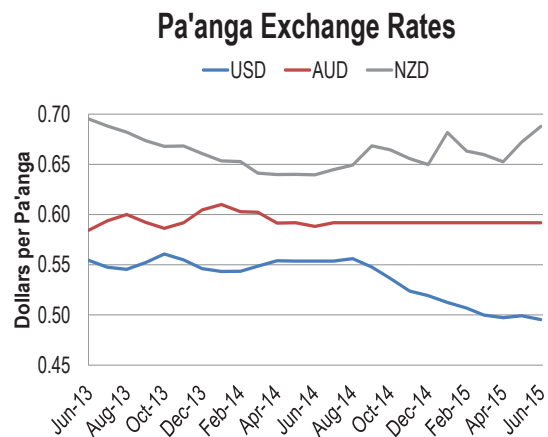
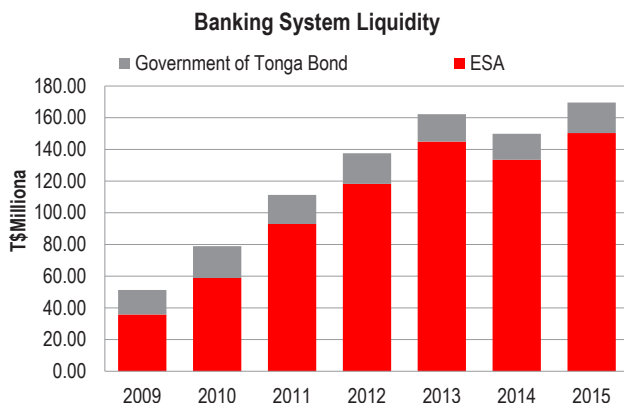
during the year. The interest rate for repurchase agreements therefore remained unchanged at 3.9% during the year.

Foreign Exchange Operations

The Reserve Bank determines the rate at which the Tongan pa'anga is exchanged for foreign currencies on a daily basis by reference to a weighted basket of currencies of Tonga's major partners in foreign trade and foreign receipts and payments transactions. Following the review of the exchange rate currency basket in June 2014, the revised currency basket weights became effective on 1 July 2014. The exchange rates set on a daily basis generally form the basis of the commercial banks' publicly quoted foreign exchange dealing rates.

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

The Tongan pa'anga fluctuated against the US dollar (USD) and the Australian dollar (AUD) in wider bands in 2014/15, compared to last year. This reflected the increased volatility in the USD and AUD during the year. Meanwhile, the volatility of the New Zealand dollar (NZD) was lower in 2014/15 compared to the previous year. This largely reflects the strengthening of the USD against all major currencies during the year and the AUD weakening at a relatively larger magnitude compared to



the NZD due to relatively stronger economic prospects in New Zealand.

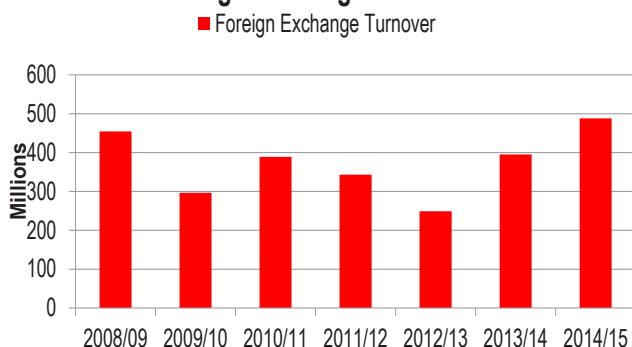
Foreign Reserves Management

The Reserve Bank Portfolio

The gross official foreign reserve was maintained well above the benchmark of 3 to 4 months of imports. As at the end of June 2015 the level of foreign reserves was at T\$289.7 million which was equivalent to 7.9 months of import cover. The foreign reserves ranged between 7.5 months and 9.1 months of import cover during the year. The level of gross official reserves peaked at a record high of T\$293.6 million which was equivalent to 7.8 months of import coverage as at the end of December 2014, compared to T\$274.4 million and 9.1 months of import as at 30 June 2014. The significant increase in the level of foreign reserves was attributed mainly to significant receipts of budget support for the Government.

During the year, the Reserve Bank was a net purchaser in the spot foreign exchange markets. Foreign exchange purchases of T\$248.5 million exceeded sales of T\$239.6 million giving a total foreign exchange turnover for the year of T\$488.1 million, an increase from T\$395.0 million last year. The Reserve Bank also conducted foreign exchange operations for its other customers mainly the Government, and for its own account, in a range of currencies.

Foreign Exchange Turnover



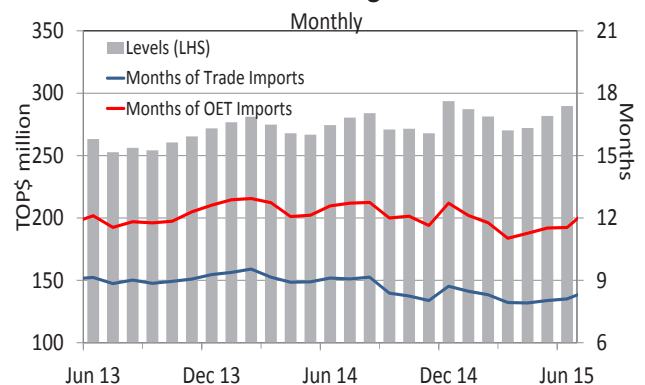
The management of the foreign reserves met the objectives of safety, liquidity and profitability. The currency composition of the foreign reserves was mainly in US dollars, Australian and the New Zealand dollars.

The Bank's investment policy is to obtain the maximum income commensurate with safety, liquidity and the maintenance of overall value which continued to be

a challenge, given the uncertainty and volatility in the global financial markets and continued low interest rates in the trading partner countries. The currency composition therefore deviated from the benchmark portfolio but remained within the Board approved limit, in order to maximize income and maintain the value of the foreign reserves. The currency composition exposes the Bank to exchange rate risk. However, the Reserve Bank continued to closely monitor the implications of the movements of the exchange rates on the value of the foreign reserves. Against the background of lower interest rates in the global markets coupled with the general appreciation of the Tongan pa'anga against the NZD and AUD, the income on the investment of the foreign reserves declined by \$2.1 million compared with the previous year, despite the significant increase in the level of foreign reserves by \$15.3 million.

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

Gross Official Foreign Reserves



Source: Banking System; Statistics Department; Foreign Exchange Dealers

Exchange Control Operations

During 2014/15, the Reserve Bank processed 722 exchange control applications for payments of amounts above the delegated limit and all capital payments as stipulated in the Exchange Control guidelines. The approved exchange control applications amounted to T\$212.3 million in 2014/15 (of which 11% were classified as capital transactions) compared to the 728 exchange control applications (11% capital transactions) processed in 2013/14 amounting to T\$226.2 million. The decrease in the number of exchange control applications and the total amount of the applications re-

flect lower valued and less applications were processed during the year. The exchange control data on foreign currency payments by large importers were key inputs to the Reserve Bank's foreign reserves forecast and monetary policy decisions.

The Reserve Bank also received 47 applications for the removal of foreign currency cash over T\$10,000 across the border, of which all applications were approved totaling T\$35.6 million. This is an increase from 38 applications totaling T\$26.2 million last year. This increase is attributed to more applications for export of cash by banks and foreign exchange dealers due to favorable exchange rates offered overseas.

Spot checks were conducted during the year to ensure banks and licensed foreign exchange dealers were compliant with the exchange control guidelines. The annual review of the Exchange Control Policy Guidelines was completed during the year and came into effect on 1st May 2015. Training with the banks and foreign exchange dealers were conducted to improve their understanding of the exchange control requirements.

The review of the Foreign Exchange Control Act and Regulations is in progress to be finalized in 2015/16. One of the main objectives of this review is to ensure all foreign exchange due to Tonga are captured which would support the Reserve Bank's role of maintaining the foreign reserves at adequate level. In addition, the Reserve Bank's enforcement powers will be strengthened.

Export Proceeds

The Reserve Bank continued to work towards setting up a framework for the return of export proceeds to Tonga. The export trade data collected from Customs and data on export proceeds were analyzed to better understand the proportion of export proceeds being remitted back and the lag period between the shipment of export and the receipt of the export proceeds.

Over the year to June 2015, 43% of the total export value was remitted back through the banking system. This was mainly driven by fish proceeds of about 29%. This could be due to lag period for exporters to remit funds back and other factors such as funds left abroad for repayment of overseas obligations and also minimization of exchange rate risks. Furthermore, the analysis indicated that the data distortions identified in previous years generally have not improved such as possible understating of trade export data and the inconsistency in the exporters recorded by Customs and the licensed exporters recorded by the Ministry of Commerce, Tourism and Labour. On the other hand, there have been improvements in the reconciliations between the Customs export data and some of the shipping companies' export data. In this regard, more work needs to be done to improve the quality of the exports data as well as find a reliable source for the pricing of exports to ensure appropriate valuations of exports are done. The review of the Foreign Exchange Control Act to incorporate a legal framework to facilitate the establishment of an export proceeds monitoring regime is in progress for finalization in 2015/16. Consultations with relevant stakeholders are to be carried out to discuss how best to ensure the proposed framework works effectively.



Exchange Control Training with Foreign Exchange Dealers