

Economic Overview

Overseas Economies

The International Monetary Fund (IMF) reported in its April 2017 World Economic Outlook (WEO) that global growth is expected to improve in 2017 and 2018 than previously anticipated in the October 2016 WEO. More specifically, growth is expected to rise by 3.5% in 2017, an upward revision from 3.4% in 2016 and is expected to remain steady at 3.6% in 2018. These revisions stemmed from strong economic growth in a number of emerging markets and developing economies. This further reflects a pickup in confidence and other potential monetary policy easing for advanced economies which include the United States (US), Europe and Japan. Recovery in commodity prices have lifted global headline inflation and reduce deflationary pressures. The oil prices are expected to rise to an average price of US\$55 per barrel in 2017/18, compared with an average of US\$43 per barrel in 2016. This is due to further expectations of supply cuts in oil production and commitments by influential oil exporting countries such as Saudi Arabia to cut production beyond its initial indication in the OPEC agreement.



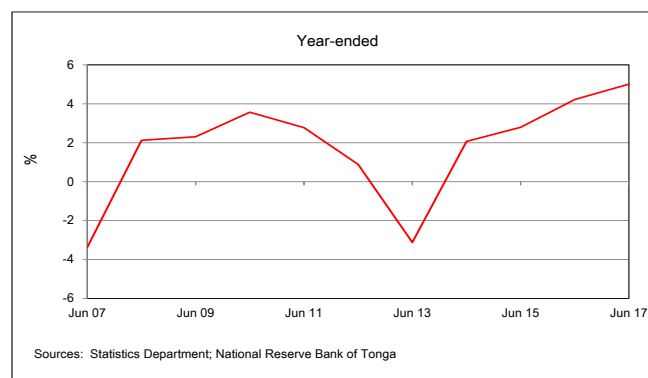
Tongan squash at the Pack-House ready to export

Developments in the Domestic Economy

The Tongan economy continued to grow for the fourth consecutive year reaching its highest annual growth rate since 1998/99 (National Account Statistics 2016/17), which was a 5.0% growth in Real Gross Domestic Product (GDP). This follows an expansion of 4.2% in 2015/16. The growth was mainly driven by strong growths in the construction, trade, transport, communication and agricultural sectors. This official growth estimate is much higher than the forecast by the Reserve Bank and the IMF of 3.7% and 3.6% respectively.

The primary production grew by 1.3% in 2016/17 driven by activities in the agricultural sector. Total agricultural exports volume rose over the year by 2,875.9 tonnes (33.0%), attributed mainly to the favourable weather conditions which resulted in higher exported volumes of root crops, squash, watermelon, and breadfruit. The largest growth was recorded in exported root crops which increased by 2,992.7 tonnes (105.0%), followed by a 344.9 tonnes (9.2%) rise in the export of squash. This outweighed a decline in the export of kava-Tonga, coconuts, sandalwood, vanilla, onion, and Indian mulberry (nonu) juice over the year. Exported kava-Tonga declined by 81.3 tonnes (49.0%) largely as a result of the drought in 2015.

Figure 1: Real GDP Growth



The industry sector recorded a strong growth of 11.1% in 2016/17. The construction activities in the country contributed to a strong performance in the secondary production. A 16.4% growth in the construction sector in 2016/17 was supported by an increase in private household housing loans and an increase in business loans for construction, manufacturing and utilities. The developments in the construction sector are expected to also have spill over effects on the utilities sector, mining and quarry and other sectors of the economy such as trade and transport and communication.

In terms of tertiary production it grew by 3.4%. Partial indicators reflect further growth in consumption activities which support a 7.7% growth in the trade sector in 2016/17. The Recognized Seasonal Employees (RSE) together with the Seasonal Worker Program (SWP) schemes and the increase in banks' personal loans to private individuals contributed to higher consumer spending power which fuelled the expansion in trade. In the year ended June 2017, total number of container registrations rose by 987 containers (10.0%) which was driven by the 905 (21.3%) rise in private containers indicating a rise in the informal distribution sector. The large number of events and celebrations held during the year, and the increase in private construction supported this annual growth. In addition, there was an increase of 38 cargo ships docked and unloaded during the year to June 2017 compared to the previous year. Expansion in the trade sector may also indicate growth in the transportation sector. The upgrade and extension of the Fuaa wharf which is scheduled to be completed in 2018, will contribute significantly to improving the safety and quality of domestic inter-island transportation, and further support economic activity. Furthermore, there were 3,710 total vehicles registered in 2016/17, a 672 (22.1%) increase compared to the previous year. Banks' total vehicle loans to individuals increased by \$0.3 million (39.0%) over the year to June 2017.

Performance of the tourism industry grew by 3.7% in 2016/17 supported by events that took place during the year, the opening of the Tanoa International Dateline Hotel, increased cruise ship arrivals, and international games such as rugby and judo hosted domestically. Total international arrivals increased by 11,713 passengers (10.5%) in 2016/17 due mainly to an increase in cruise ship arrivals of 8,236 visitors (45.3%). This was due

to larger cruise ships arriving in Tonga, and 2 additional cruise ships arriving during the year. The visa waiver agreement between China and Tonga came into effect in December 2016 when a cruise ship Costa-Atlantica arrived in Tonga with about 2,000 Chinese tourists. Additionally, Tonga is now popular as a cruise destination and that Vuna Wharf is now a reliable port for international cruise liners. It supports the small tour and taxi operators as well as handicraft sellers.

Monetary Policy Formulation

Monetary Policy Actions

The Reserve Bank maintained its current monetary policy stance in 2016/17. During the 2016/17 financial year, the Reserve Bank revised its inflation reference rate from a range of 6%-8% to a rate of 5%. Despite the significant increase in the annual inflation rate in June 2017 up to 10.3%, the foreign reserves remained at comfortable levels above the minimum range of 3 – 4 months of import cover at around 7 months of import cover, exchange rates were competitive, the banking system remained sound with strong capital and liquidity position maintained and the domestic economy experienced favourable growth as projected.

The Reserve Bank continued to monitor the movements in inflation which included assessing the effects of exchange rate movements, new tax introduced and also the businesses' profit margins, on inflation, and projected that it was a temporary hike and that inflation will return below the reference rate in 2017/18.



Ha'apai Agriculture Show, July 2016.

The focus of the Reserve Bank's monetary policy actions was therefore to adopt measures, as outlined below, to encourage the utilization of the excess liquidity in the banking system to increase lending in order to support domestic economic growth, and strengthen the monetary policy transmission mechanism in the medium term. The Reserve Bank remained vigilant for any signs of overheating risks in the economy particularly risks attached to strong credit growth.

- Maintained the monetary policy rate (interest rate on banks' exchange settlement accounts or excess reserves) at 0% (zero interest rate policy).
- Maintained the minimum loans/deposit ratio at 80% to be achieved by June 2017, 85% by December 2017 and 90% by June 2018;
- Increased the Statutory Reserve Deposit ratio from 5% to 10% effective in July 2017;
- Maintained the inflation reference rate at 5% since November 2016;
- Eased the Exchange Control requirements effective in February 2017 to assist individuals and business in making foreign exchange payments and thereby provide an accommodative business environment;
- Continued to closely monitor the effects of the eased Foreign Exchange Control requirements and economic development on the foreign reserves;
- Engaged technical assistance from the IMF to consider using open market operation (such as the issuance of NRBT notes) to mop up the excess liquidity in the system and help develop the domestic market in order to be more market based and efficient in

the issuing of securities, which would in turn provide local investment opportunities and avoid pressure on the foreign reserves through outgoing capital investments;

- Continued with the financial inclusion initiatives to improve access to financial services and provide further protection to the consumers through the regulation of non-bank financial institutions, introduction of a financial consumer protection policy, and enhancement of consumers' financial literacy.
- Improved the transparency of monetary policy by announcing policy decisions approved by the Reserve Bank Board of Directors shortly after monthly Board meetings. This was effective since January 2017.

Monetary Policy Outcomes

The headline inflation started rising in July 2016 and remained relatively high during 2016/17. The annual headline inflation edged higher in June 2017 rising by 10.3%, the highest headline inflation in 2016/17. The same period in 2016 recorded a very low annual inflation of 0.1%, which also had lower level of imported and local prices. Imported prices rose by 11.7% over the year to June 2017 contributing 6.5 percentage points to the annual headline inflation. The prices of all imported food categories rose, except for imported fruits and vegetables, and this was led by a 26.6% increase in price of meat, fish & poultry reflecting a rise of 41.5% and 33.5% in the price of mutton flap and chicken pieces respectively. This was followed by a 10.8% rise in the prices of other food components which included goods such as sugar whose price rose by 21.6%.

The higher prices of imported meat continued to reflect the excise taxes and custom duties imposed on various imported food in July 2016. Similarly, the price of Winfield blue tobacco rose by 29.2%. Additionally, the increase in world oil prices drove the price of fuel higher by 10.1%, diesel and petrol prices rose by 16.0% and 14.5% respectively. Furthermore, the price of fuel and power under the household operations increased by 10.8% which comprised of kerosene and liquid petroleum gas.

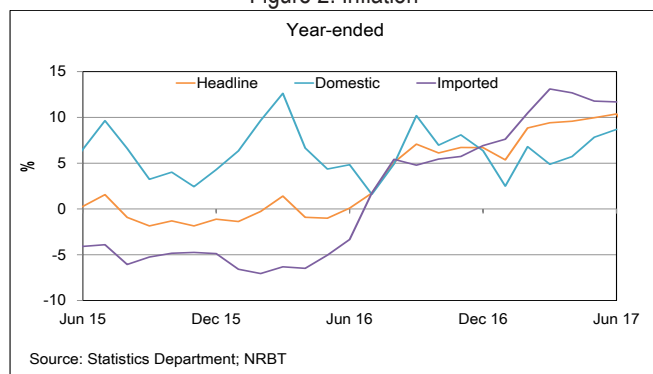
Domestic inflation rose by 8.7% over the year to June 2017 accounting for 3.8 percentage points of the headline inflation. This was driven by the seasonality of local food, rise in electricity price, and the continued short



Harvesting of potatoes

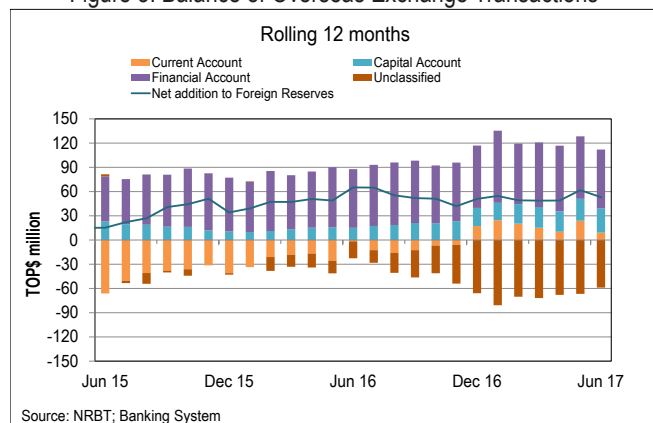
supply of kava-Tonga. The price of local food rose by 10.2% contributing 2.1 percentage points to the overall headline inflation due to the prolonged dry weather in 2017 for growing vegetables compared to the same period in 2016. The increase in oil prices drove the electricity price higher by 22.7%, and kava-Tonga price rose annually by 43.0%.

Figure 2: Inflation



Over the year to June 2017, total OET (Overseas Exchange Transactions) receipts rose by \$94.3 million (14.4%) to \$749.1 million driven by higher inflows of private remittances and travel receipts. The celebrations and annual events during the year supported the annual growth in remittances. Similarly, total OET payments continued to rise by \$68.2 million (12.0%) to \$636.9 million in the same period which was attributed to higher import and service payments, particularly payments for wholesale & retail goods and freight. The overall OET balance for the year ended June 2017 was therefore a surplus of \$53.0 million, equivalent to USD\$24.2 million which is more than the IMF's projection of a surplus of USD\$3.5 million. Compared to June 2016, the overall balance was lower by \$12.2 million (18.6%) compared to a year ago.

Figure 3: Balance of Overseas Exchange Transactions



This contributed to the rise in the official foreign reserves to \$407.9 million in June 2017, sufficient to cover 7.4 months of imports, which is still above the Reserve Bank's minimum range of 3 – 4 months. The level of foreign reserves at the end of June was equivalent to USD \$186.2 and was above the IMF's projection of USD \$169.9 million by the end of 2016/17, but with lower months of import cover of 5.8 months. A monthly press release on the level of foreign reserves is posted on to the website for the awareness of the public.

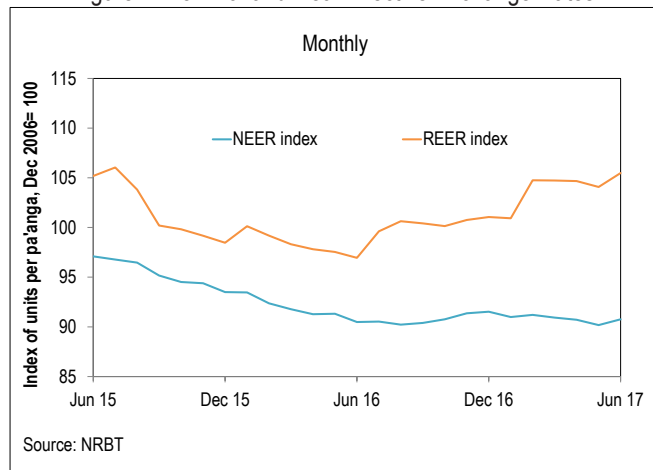
Majority of Tonga's major trading currencies have strengthened against the Tongan Pa'anga over the year to June 2017, namely the Australian Dollar, New Zealand Dollar, Fijian Dollar and the Euro while the United States Dollar, Great Britain Pound, Japanese Yen and Chinese Yuan weakened against the Tongan Pa'anga. As a result, both the Nominal Effective Exchange Rate (NEER)



Young Kava-Tonga plants ready for cultivation

and the Real Effective Exchange Rate (REER) appreciated over the year by 0.3% and 8.8%, respectively. The rise in the REER index reflected Tonga's higher headline inflation rate relative to its trading partners, which may impact the international competitiveness of the Tongan exports of goods & services.

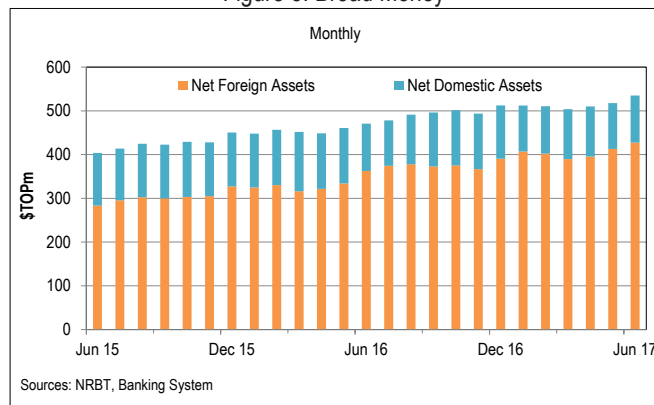
Figure 4: Nominal and Real Effective Exchange Rates



Over the year to June 2017, broad money increased by \$64.3 million (13.7%) to a new record high of \$534.9 million. This was solely a result of a significant rise in net foreign assets which increased by \$65.6 million (18.1%) outweighing a decline of \$1.4 million (1.3%) in net domestic assets. More specifically, foreign reserves continued to be the main contributor to the annual in-

crease in net foreign assets. This had offset the decline in net domestic assets. However, the annual increase in broad money was 13.7%, which was just below the Reserve Bank's forecast for June 2017 of 14.0% in its February 2017 Monetary Policy Statement (MPS). In addition, liquidity in the banking system (reserve money) increased over the year to June 2017 by \$27.2 million (10.6%) driven mainly by a \$16.2 million (9.6%) rise in banks' deposits to the Reserve Bank vault.

Figure 5: Broad Money



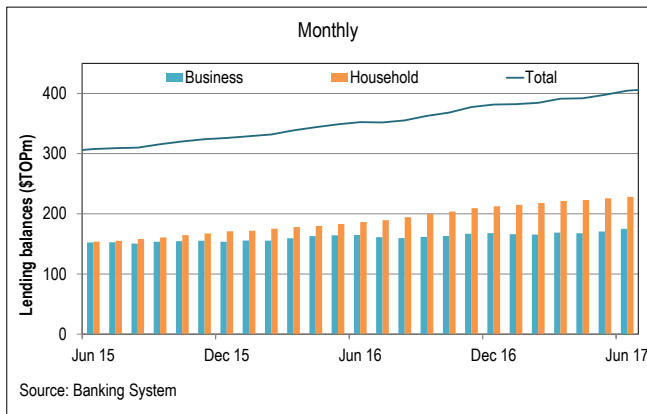
Total banks' lending increased over the year to June 2017 by \$52.2 million (14.8%) to a new high record of \$404.5 million. Housing loans continued to significantly drive higher lending to households over the year. Vehicle loans and other personal loans also contributed to the rise in lending to households. Lending to businesses rose driven by growth in loans to the wholesale & retail, services, and manufacturing sectors. This coincided and supported other evident increases in domestic economic activities throughout the year. The annual credit growth of 14.8% is very close to the Reserve Bank's estimated credit growth of 15.0% that was to be achieved at the end of 2016/17 in its February 2017 MPS. Lending activities in the non-bank financial institutions also increased over the year by \$16.5 million (13.3%) to \$140.4 million, largely reflecting an increase in household lending.

The weighted average interest rate spread widened over the year by 7.1 basis points from 5.63% to 5.70%. This was due to a decline in the weighted average deposit rate outweighing a decrease in the weighted average lending rate.



Construction of the St. George Palace, Nuku'alofa, Tonga.

Figure 6: Banks' Lending



Net credit to government declined over the year to June 2017 by \$40.5 million. This was due mainly to a rise in government deposits supported by the receipts of the budgetary support and government grant funds from development partners, as well as improved government revenue collection during the year.

Economic Corporate Plan Targets

In April 2017, a review of the 2016 corporate plan was conducted which showed the Economics Department had achieved 20 out of its 23 targets. Over the year, some targets were revised and some were added on to enhance the timeliness of the release of reports and publications and responses to stakeholders and thereby improve communication and public awareness of the Reserve Bank's functions as well as economic developments, taking the total up to 35 measurable targets under the Corporate Plan for 2017. After the first 6 months of 2017, the Economics Department was able to achieve 23 targets while 7 are included in the department's work plan for the remainder of the year. The remaining 5 targets were not achieved during the first half of the year due mainly to delays in submission of data from stakeholders and shifts in work priorities.