Financial Markets Operations

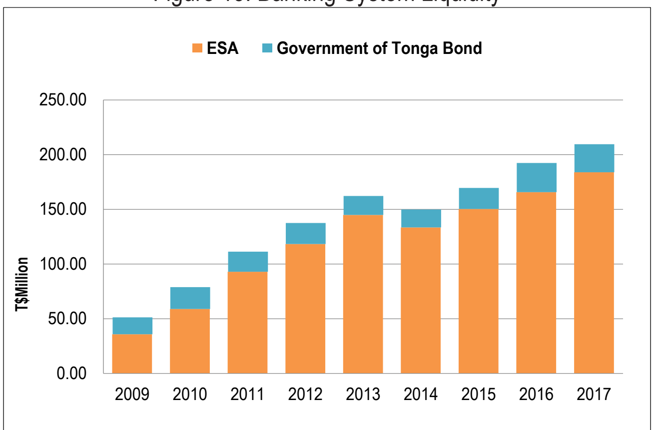
Domestic Market Operations

The Reserve Bank did not issue any Reserve Bank notes as it continued to encourage banks to use the excess liquidity in the banking system for lending to support economic growth.

As of the 30 June 2017, the banking system liquidity stood at $209.5 million, an increase from $192.3 million at the end of June 2016. The banking system liquidity comprised mainly of $183.9 million in the banks' Exchange Settlement Accounts (ESA) held with the Reserve Bank and $25.6 million of Government of Tonga's Bonds held by the banks. The higher liquidity was in line with the higher foreign reserves.

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. As a result of the growing excess liquidity, the Reserve Bank notified the banks of its intention to increase the statutory reserve deposits (SRD) rate from 5% to 10% in the 2017/18 financial year to encourage prudent practices whereby a portion of the excess liquidity is set aside as a precaution against the growth in credit and to strengthen the monetary policy transmission mechanism.

Figure 13: Banking System Liquidity



The Reserve Bank continued to publish financial information, such as comparisons of financial institutions' daily and weekly exchange rates and fees related to foreign exchange transactions, in its efforts to improve the public's understanding of financial indicators in order to make better financial decisions.

The Reserve Bank is also exploring other avenues and mechanisms in order to develop the domestic market operations in the near future to be more market oriented. Amendments to the NRBT Act approved in February 2017 allows the utilization of the excess balance in the Revaluation Reserve Account, above $10 million, to cover the Reserve Bank's monetary policy costs. This enhances the Reserve Bank's ability to issue NRBT notes to implement the monetary policy and thereby develop the domestic market. This amendment also allowed the excess balance in the Revaluation Reserve Account to be paid to the Government upon the request of its Minister and approved by the Reserve Bank Board.

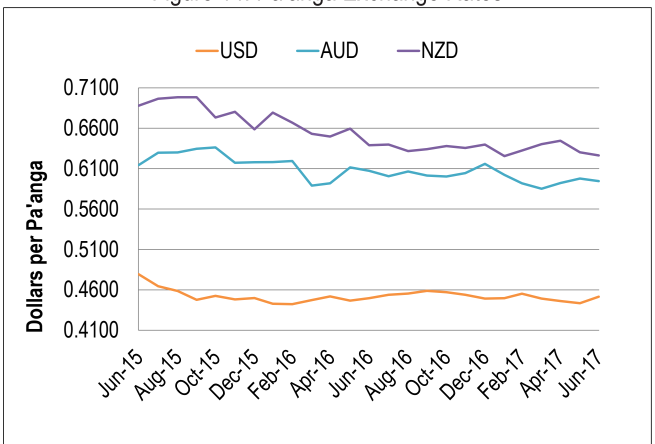
Foreign Exchange Operations

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. 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. According to an evaluation by the IMF staff visit in March 2017, the value of the pa'anga is in line with fundamentals, and there are no signs of deteriorating competitiveness. However, should pressure on the foreign reserves emerge, the Reserve Bank should stand ready to depreciate the Pa'anga against the basket of currencies in order to safeguard external stability.

Over the year ended June 2017, Tongan pa'anga fluctuated against the US dollar (USD), Australian dollar (AUD) & New Zealand dollar (NZD) in narrower bands, compared to last year reflecting decreased volatility in all three currencies during the year. The USD weakened against the AUD and NZD. Uncertainties in the US political arena contributed to the declining USD while interest rate hikes by the Federal Reserve did very little to buy the currency due to its negative effects on US security yields. The AUD and the NZD also gained on the weak USD due to relatively stronger economic prospects in the respective countries. As such, the TOP appreciated against the USD while it depreciated against the AUD and NZD over 2016/17.

Figure 14: Pa'anga Exchange Rates



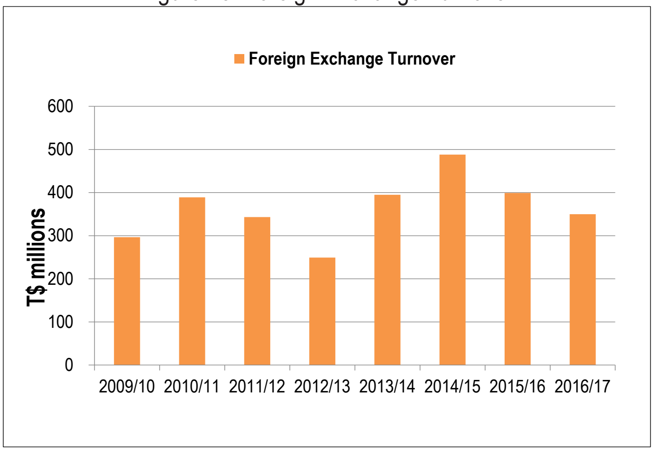
The Reserve Bank also continued to monitor the commercial banks' exchange rates spreads to ensure that they were in compliance with approved limits that were set by the Reserve Bank. Despite the introduction of the levy on foreign exchange transactions in June 2016, the spread limits were not revised. The Reserve Bank in collaboration with the Association of Banks in Tonga (ABT) also directed the banks not to pass on the levy burden to customers through an additional fee. These directives meant that the banks would absorb the levy burden within their own profit margin instead of passing it to the public. The Reserve Bank paid T$0.482 million in levy to the Ministry of Finance during 2016/17.

Foreign Reserves Management

The Reserve Bank Portfolio

The gross official foreign reserves was maintained well above the minimum range of 3 to 4 months of import cover. The level of foreign reserves peaked at a record high of T$412.1 million during June 2017 before settling at T$407.9 million, equivalent to 7.4 months of import cover, by the end of the month compared to T$354.9 million (7.2 months of import cover) as at 30 June 2016. The significant increase in the level of foreign reserves was attributed mainly to receipts of budget support for the Government. The Reserve Bank continues to monitor the banks' compliance with their respective nostro limits and that excess is sold to the Reserve bank as part of its foreign reserves management tools.

Figure 15: Foreign Exchange Turnover

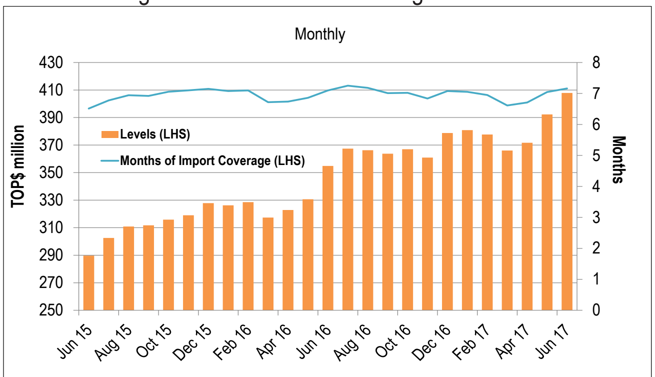


During the year, the Reserve Bank was a net purchaser in the spot foreign exchange markets. Foreign exchange purchases of T$201.6 million exceeded sales of T$148.3 million giving a total foreign exchange turnover for the year of T$349.9 million. This is a decrease from T$399.1 million last year due mainly to a fall in volume of foreign exchange transfers by the Reserve Bank. The Reserve Bank conducted foreign exchange operations for its customers, but especially the Government, and for its own account in a range of currencies.

The management of the foreign reserves during 2016/17 met the objectives of safety, liquidity and profitability. The currency composition of the foreign reserves was mainly in US dollar, Australian dollar and the New Zealand dollar.

The Reserve Bank's investment policy is to obtain the maximum income commensurate with safety, liquidity and the maintenance of the 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 therefore exposed the Reserve Bank to exchange rate risk hence the Reserve Bank continued to closely monitor the implications of the movements of the exchange rates on the value of the foreign reserves. Despite lower interest rates in the global markets, the income on the investment of the foreign reserves increased by $0.28 million in 2016/17 compared with the previous year, which was in line with the significant increase in the level of foreign reserves of $53 million.

Figure 16: Gross Official Foreign Reserves



Sources: Financial Markets; Economics Department

The Reserve Bank complied with all the Board approved risk parameters for the management of the foreign reserves during the year which included ensuring that investments were held with banks rated above the Board approved minimum "A" rating by international credit rating agencies and minimizing concentration of investments in one bank. In June 2017 the Board of Directors approved that the limit on total deposits or investments per bank be increased from T$90 million to T$130 million due to the increase in foreign reserves and to maximize income from banks with the best yields. The Reserve Bank secured technical assistance from the IMF to review and provide recommendation on how to improve the management of the foreign reserves, which is scheduled for August 2017.

Exchange Control Operations

During 2016/17, the Reserve Bank completed the annual review of its Exchange Control policies and guidelines and eased the exchange control requirements to be in line with the very high level of foreign reserves and the outlook for the foreign reserves to remain at comfortable levels, the current monetary policy stance, as well as the need to improve the clarity of the requirements as per feedback received from banks, the authorized restricted foreign exchange dealers, and the general public. The revisions were as follows:

1. The delegated limit of T$100,000 to the banks and authorized restricted foreign exchange dealers will now also apply to capital payments that previously had no delegated limit such as loan repayments, offshore investment, dividend payments to non-resident investors and migrant transfers (except for loans to residents controlled by nonresidents).
2. The monthly limit for gift payments of $5,000 per month is removed. This means that anyone can send gift payments overseas for amounts up to $50,000 per annum per remitter per beneficiary in any given time of the year.
3. The delegated limit of $5,000 per transaction per remitter applicant without supporting documents previously removed is now reinstated.
4. The requirement to provide visas for payments for travel, education and medical expenses, and export of cash is removed.
5. The requirement to provide evidence of funds received from offshore for loan repayments and wages paid in foreign currency cash to foreign crew members is removed.
6. The requirement with regards to the overseas recipient of payments for education and medical expenses has been expanded to include third parties.

As such, the Reserve Bank processed 776 exchange control applications for current and capital payments of amounts above the delegated limit of $100,000. The approved exchange control applications amounted to T$223.5 million in 2016/17 (of which 14% were classified as capital transactions) compared to the 825 exchange control applications (8% capital transactions) processed in 2015/16 amounting to T$198.4 million. The exchange control unit achieved its target for a half day turnaround time for processing and approval of applications, provided that all the submitted documents met the requirements. The exchange control data on foreign currency payments by large customers including the Government and large importers were key inputs to the Reserve Bank's foreign reserves forecast and monetary policy decisions.

The Reserve Bank also received 62 applications for the removal of cash (both Tongan pa'anga and foreign currency notes totaling T$10,000 and above) across the border which were all approved and amounted to a total of T$46.9 million. Last year, 67 applications were approved totaling T$45.9 million. Despite the decrease in the number of applications the value of these transfers increased as banks and foreign exchange dealers preferred favorable exchange rates offered from overseas. The exchange control unit also notified the Ministry of Revenue and Customs of all approved applications for exports of cash, two (2) days before the date of travel, with some exceptions due to late submission of applications from banks, authorized restricted foreign exchange dealers, and individual applicants.

Quarterly spot checks were conducted during the year to ensure banks and authorized restricted foreign exchange dealers were compliant with the exchange control guidelines. Meanwhile, internal monitoring of compliance is also carried out through other reports such as the Overseas Exchange Transactions (OET), Foreign exchange transactions with value that is equivalent to T$50,000 and above (FX above 50K), Forward exchange contracts (FEC) and the Foreign currency accounts (FCA). Press releases were posted on the website, and trainings with the banks and authorized restricted foreign exchange dealers were conducted to keep them informed of any revisions to the exchange control guidelines and to also raise issues identified from the spot checks. The Reserve Bank still continued to issue the Gift list for those who have reached their annual delegated limit of T$50,000 and a Caution list for those who had nearly exhausted their annual delegated limit for gift payments (T$45,000 up to T$50,000). In addition, a Travel list is also issued for those who have breached the delegated limit for Travel allowance of T$20,000 per travel. In cases of breaches, customers will be referred to the Reserve Bank for approval and further monitoring to ensure they consistently comply with the exchange control requirements, and also ensure payments made are bona-fide transactions to help with anti-money laundering initiatives.

Financial Market Corporate Plan Targets

At the end of the first half of 2016/17, a review of the 2016 corporate plan was conducted which showed the Financial Markets Department had achieved 30 out of the 39 targets, while only 9 were still outstanding. Due to recent global and domestic developments, some targets were revised and other targets were also added taking the total up to 42 targets for the financial markets department to implement in order to enhance the operations of the Reserve Bank. These include revisions to the Reserve Bank's budgeted income due to movements in global exchange rates and interest rates, revisions to the Reserve Bank's internal inflation reference rate to be in line with recent developments and the inclusion of recommendations by the IMF technical assistance mission on domestic market development in the corporate plan targets.

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