NATIONAL RESERVE BANK OF TONGA

Monetary Policy Statement

August 2017

NATIONAL RESERVE BANK OF TONGA

Monetary Policy Statement

August 2017

Issued by: National Reserve Bank of Tonga
Salote Road
Nuku'alofa
Tonga.

Postal Address: Private Mail Bag No. 25
Post Office
Nuku'alofa
Tonga
South Pacific

Enquiries:

Phone:	(676) 24-057
Facsimile:	(676) 24-201
Email:	nrbt@reservebank.to
Telex:	94079763 NRBT G
Swift BIC code:	NRBTTONU

Subscription: Economics Department
National Reserve Bank of Tonga
Private Mail Bag No. 25
Post Office
Nuku'alofa
Tonga
South Pacific

Contents

List of abbreviations

AUD	Australian Dollar
BSP	Bank of South Pacific
EXIM	Export-Import
EU	European Union
FEDs	Foreign Exchange Dealers
GDP	Gross Domestic Product
HTFA	High Temperature Forced Air
IMF	International Monetary Fund
JPY	Japanese Yen
LDS	Latter Day Saints
MAFF	Ministry of Agriculture, Food & Forests
MPS	Monetary Policy Statement
MSMEs	Micro Small and Medium Enterprises
NBFIs	Non-Bank Financial Institutions
NEER	Nominal Effective Exchange Rate
NRBT	National Reserve Bank of Tonga
NZD	New Zealand Dollar
OET	Overseas Exchange Transactions
OPEC	Organization of the Petroleum Exporting Countries
RBA	Reserve Bank of Australia
RBNZ	Reserve Bank of New Zealand
REER	Real Effective Exchange Rate
RFB	Retirement Fund Board
ROA	Return on Assets
ROE	Return on Equity
RSE	Regional Seasonal Employees
TOP	Tongan Pa’anga
UK	United Kingdom
US	United States
USD	United States Dollar
WEO	World Economic Outlook

Overview

Recent Development

The Reserve Bank maintained its current accommodative monetary policy stance. This supported the monetary policy objectives of maintaining internal and external monetary stability, promoting financial stability and a sound and efficient financial system and conducting its activities in a manner that supports macroeconomic stability and economic growth. This was by ensuring adequate level of foreign reserves was maintained above 3 – 4 months of import cover, despite annual headline inflation remaining slightly above the reference rate of 5% annually up to August 2017 although it had declined from the high level 6 months ago.

The Statistics Department has yet to release its official estimates of real GDP for 2016/17, however the Reserve Bank's outlook for a stronger real GDP growth of 3.7% in 2016/17 remains which is higher than the 2.7% growth projected by the IMF Article IV mission in September 2017. This growth outlook continues to be driven by developments in the construction, utilities, fisheries, and mining & quarry sectors. The number of events that took place during the year and partial indicators showing improvement in economic activities in 2016/17, support this overall strong growth projection.

Inflationary pressures eased in August 2017 reflecting the wind down of the hike in prices last year when the new excise tax became effective in July 2016. The annual headline inflation slowed to 5.2% in August 2017 from a high of 8.9% in February 2017 and a 5.1% increase in August 2016. This is slightly higher than the Reserve Bank's inflation reference rate of 5% per annum.

Over the past six months to August 2017, the overall balance of OET was a surplus of $27.4 million, which contributed to a rise in the official foreign reserves to $405.0 million. This was more than double the surplus recorded for the past six months to February 2017 of $11.4 million.

Gross official foreign reserves continued to rise to another record high of $405.0 million in August 2017, compared to $377.7 million in February 2017. This was sufficient to cover imports of merchandise goods and services for 6.9 months[1], which remained above the Reserve Bank's minimum range of 3-4 months of import cover. In year ended terms, gross official foreign reserves rose by $38.8 million. The surplus in the current account balance is as a result of higher remittances, higher receipt of foreign aid from donor partners and budgetary support for the Government, which contributed to the higher foreign reserves over the past year.

Over the 6 months to August 2017, the banking system continued to remain sound. The capital position remained strong, high liquidity and strong profitability was maintained, and non-performing loans remained low. Steady growth in total lending continued, which reached a new record high of $415.6 million in August 2017. Growth in deposits climbed to new heights as well, coinciding with the high level of foreign reserves. Furthermore, the weighted average interest rate spread narrowed slightly over the period.

Despite the rise in the Statutory Required Deposit ratio from 5% to 10% in July 2017, liquidity in the banking system (reserve money) increased over the last 6 months to August 2017 by $4.9 million (1.8%) to $282.9 million. Higher deposits over the past 6 months supported the growth in reserve money. Broad money rose over the last 6 months to August 2017 by $42.1 million (8.3%) to a record high of $552.3 million compared to $510.2 million in February 2017. This was driven by a $26.8 million increase in net foreign assets and a $15.2 million growth in net domestic assets. The banks' total loans to deposit ratio rose in August 2017 to 75.2% from 73.3% in February 2017, due to a credit growth of $31.1 million (8.1%) outweighing a $28.1 million (5.4%) increase in deposits. This ratio continued to remain below the 80% minimum requirement which indicates excess liquidity in the banking system remains and that there is capacity for further lending by banks. The Reserve Bank will continue to monitor the lending growth to avoid any overheating in the economy.

[1] Method of calculation has changed in February 2017 to include both imports of goods & services (previous method used imports of goods only)

Banking system data shows the net credit to Government continued to fall by $17.2 million (18.2%) over the 6 months to August 2017. This was due to an increase in government deposits, which reflected higher Government receipts during the period.

Outlook

The 2017/18 real GDP growth estimate has been revised down to 4.0% compared to the February 2017 MPS projection of 4.8%. This downward revision to the growth outlook is mainly driven by the cancellation of Tonga's hosting of the 2019 Pacific Games which will slow down growth that was projected for the secondary and tertiary sectors of the economy. However, this growth is still above the 2017 IMF Article IV's projection of 3.4% growth.

The Reserve Bank expects the inflationary pressure to remain in the near term due to the impact of the further increase in custom duty and excise tax effective in July 2017. However, the annual headline inflation is forecasted to gradually decline below the reference rate of 5% per annum after February 2018. The movements in global food and oil prices may pose a risk to this outlook. Additionally, the vulnerability of Tonga to natural disasters poses a risk to the local food prices and consequently the inflation outlook. The Reserve Bank will closely monitor the sources of higher inflation which include assessing the effects of exchange rates, new tax introduced and also the businesses' profit margins.

The level of foreign reserves is also expected to remain at comfortable levels above the minimum range of 3-4 months of import cover, supported by expected higher receipts of remittances and export proceeds, and anticipated Government receipt of budget support and grant funds from development partners. This will be partially offset by the projected rise in imports. The Reserve Bank forecast the level of foreign reserves to increase to $424.3 million in June 2018 (6.6 months of import cover), which is higher than the IMF Article IV projections of $411.8 million (5.9 months of import cover).

The Reserve Bank's credit growth forecast for 2017/18 remains at 15% as published in the February 2017 Monetary Policy Statements (MPS), which is lower than the IMF Article IV projection of 16.6% for 2017/18. The Reserve Bank's monetary policy stance to utilize the excess liquidity to encourage lending in order to support economic activities, would support the anticipated continued growth in credit and broad money. At the same time, continued structural reforms as well as improvements to the credit environment such as the improvements to the land administrative system, a bankruptcy laws and an effective credit bureau would improve the banks confidence to lend further in a prudent manner. The Reserve Bank had issued the Credit Bureau Licencing Guidelines in early 2017 and continues to look at other options to establish a credit bureau in Tonga and ensure it is carrying out its role efficiently. The banks' outlook for credit growth remains positive and the Reserve Bank's projection is supported by the continuous improvements in business confidence, improving economic conditions and ongoing annual events. Non-performing loans is also likely to decline in the near future.

Net credit to the Government is also anticipated to decline as a result of expected government budgetary support and grants receipts, as well as improved Government revenue collection.

Given the recent developments and the outlook on the monetary policy objectives and macroeconomic and financial soundness indicators, the accommodative monetary policy stance is maintained however the Reserve Bank will remain vigilant and continue to closely monitor developments in the domestic and global economy for early signs of vulnerability or overheating of the economy. Furthermore, the Reserve Bank will continue to update its monetary policy setting to maintain internal and external monetary stability and to promote a sound and efficient financial system, in order to support macroeconomic stability and economic growth.

Sione Ngongo Kioa
Governor

1. Global Developments

World Growth

The IMF World Economic Outlook (WEO) in October 2017 reported that global growth continued to strengthen. As such, the global growth forecast was revised upwards from 3.5% to 3.6% for 2017 and from 3.6% to 3.7% for 2018. The main drivers for this upgrade included improvements in global investment, trade, and industrial production. Firmer domestic demand occurred throughout the first half of 2017 particularly for advanced economies and some large emerging market economies such as China.

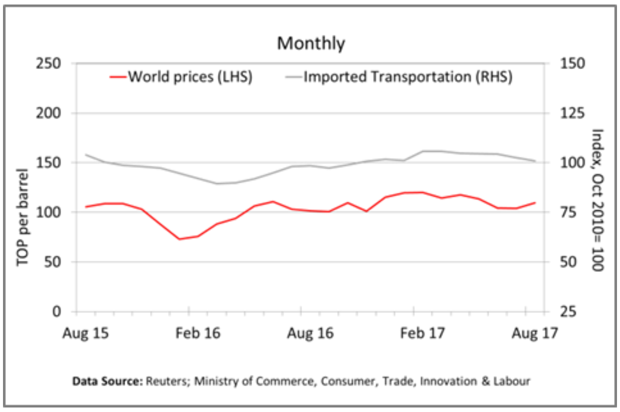
Furthermore, growth outcomes in the first half of 2017 were stronger than expected which contributed to the upgrade of the global growth forecast. Economic growth forecast for the Euro Area, Japan, emerging Europe, and Russia were also upgraded. Meanwhile, growth forecasts for the United States (U.S.), the United Kingdom (U.K.), and India were revised downwards.

Commodity prices continued to soften according to the IMF's Primary Commodities Price Index which recorded a 5% decline over the 6 months to August 2017. This included a decline in fuel prices which includes oil. This contributed downward pressure on the global headline inflation. Core inflation has generally remained below the central bank targets in most advanced economies despite the pick-up in domestic demand and lower unemployment rates. The monetary policy stance in advanced economies continued to remain broadly unchanged since the IMF April 2017 WEO.

World Oil Prices

According to Reuters, world oil prices averaged around US$51.87 per barrel in August 2017. This is a decline compared to February 2017 where prices averaged around US$55.99 per barrel. However this is significantly higher than an average of US$46.94 per barrel a year ago. The rise in oil prices over the year is a result of a reduction in supply production. This was formalized by the announcement of the production agreement by the Organization of the Petroleum Exporting Countries (OPEC) in November 2016.

Figure 1: World Oil prices



However, the recent trend for oil prices is slowly declining again. This was led by higher-than-expected U.S. shale oil production and oil production recoveries in Libya and Nigeria. Exports from OPEC countries remained at relatively high levels, even with lower production. The IMF October 2017 WEO stated that oil prices are expected to average around US$50.3 per barrel in 2017 and to remain at about this level in 2018 as well. This is rising from an average of US$43 a barrel in 2016. This projection is due to uncertainties around the impact of Hurricane Harvey on the U.S. refinery capacity despite crude inventories remaining high.

Advanced Economies

In the U.S., weak consumption activity during the first quarter of 2017 was temporary. Meanwhile, business investment continued to strengthen reflecting a recovering energy sector. The IMF October 2017 WEO still projects growth for 2017 to be 2.2% (same projection as the last WEO) and for 2018 to be 2.3% (downgrade from 2.5%). Inflation in the U.S. recorded a rise of 1.9% over the year ended August 2017 driven the annual increase in gasoline and rent prices. A continued rise in inflation could lead to tightening of the monetary policy and a stronger US Dollar. However, due to the recent decline in fuel prices, prices of cellphones, and prescription drugs, headline inflation is expected to increase by less than envisioned in the April 2017 WEO. The US Federal Reserve in its statement on November 2017 stated that stance of monetary policy remains accommodative and maintained its interest rate at 1.25 percent.

The Reserve Bank of Australia (RBA) reported in its August 2017 MPS that economic growth for Australia picked up in the most recent June quarter. An annual GDP growth rate of 2.1% was recorded for June 2017. This growth is still lower than the 2.5% GDP rate recorded in December 2016 and reported in the February 2017 MPS. However, strong retail sales and favorable business conditions contributed to the recent uptick in growth. Looking ahead, Australia predicts a 2.2% GDP growth for 2017 and a 2.9% GDP growth for 2018. This is a result of varying economic conditions across the states such as the stabilising mining-exposed states of Queensland and West Australia. Headline inflation was reported to be 1.9% over the year to June 2017. This was slightly lower than expected due to weaker fruit and vegetable prices. Inflation is expected to be 2.0% by the end of 2017 and further expected to be 2.3% by the end of 2018. These forecasts are a slight upward revision to what was reported in the last MPS. The forecast reflects the expectations of a gradual increase in wage growth from its current low rates. Taking into consideration the most recent developments and forecasts, the RBA Board continued to maintain its cash rate unchanged at 1.5%.

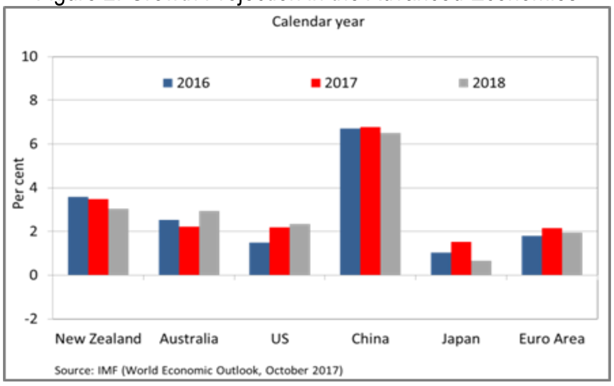
The Reserve Bank of New Zealand (RBNZ) stated in its August 2017 MPS that New Zealand experienced weaker than expected growth in the first part of the year. This resulted from temporary factors such as declines in construction activity and export volumes. Poor weather conditions over the second half of 2016 affected dairy production thus a fall in export volumes. However, GDP growth forecast is expected to rise with annual growth averaging 3.3% over next two years. This projection is underpinned by projected strengthening of consumption and business investment activities. The annual headline inflation was 1.7% in the June 2017 quarter, which was lower than the 2.2% recorded in the previous quarter. However, this was considerably higher than 0.4% recorded in the same period last year, which was driven by higher food and fuel prices. Headline inflation is projected to record a 2.4% increase before settling at 2.0% in 2018, which is within the RBNZ's target range of 1-3%. Ultimately, the RBNZ left its official cash rate unchanged at 1.75% to support strengthening GDP growth and rising capacity pressure from strong migration inflows (labour supply).

For the UK, the IMF October 2017 WEO reported a downward revised GDP growth of 1.7% for 2017 (from 2.0%) and for 2018 growth is forecasted to decline to 1.5%, which is similar to the forecast in the February 2017 MPS. This is driven by weaker-than-expected growth being realized throughout the first two quarters of this year. However, the overall growth outlook is highly uncertain and will depend on the new economic relationship between the UK and the European Union (EU). Further to that, the extent of the increase in barriers to trade, migration, and cross-border financial activity will also depend on the development of the relationship. The Pound's depreciation weighed on household income thus affecting private consumption activity further leading to softer growth. This also contributed to the headline inflation rate increasing to 2.7% over the year to August 2017. This is expected to gradually decrease to the Bank of England's target of 2% as the temporary effect of the pound's depreciation fades and inflation expectations remain well anchored..

The IMF October 2017 WEO reported that the Euro Area experienced strengthening growth momentum in the first half of the year due to stronger consumption, investment, and external demand. The Euro Area recorded an annual GDP growth of 2.2% as of August 2017. As a result, the IMF projected an upward revised growth for the Euro Area of 2.1% for 2017 (from 1.7%) and 1.9% for 2018 (from 1.6%) in comparison to the IMF's April 2017 WEO. Overall, the short term outlook for the Euro Area has improved but the medium term outlook for the Euro Area remains subdued. This is due to projected potential growth being held back by weak productivity, adverse demographics and in some countries, a public and private debt overhang. Inflation was 1.5% as of August 2017. This picked up from 0.2% in 2016 caused mainly by higher fuel prices and accommodation services. Inflation is expected to increase by 1.1% in 2017, due mainly to higher energy prices and the ongoing cyclical recovery in demand. Headline inflation is further projected to gradually approach the European Central Bank's target objective of below but close to 2% over the next two years.

China's growth remained strong supported by previous policy easing and supply-side reforms. In comparison to the IMF April 2017 WEO, the October WEO upgraded its forecast of China's economic growth to 6.8% in 2017 (from 6.5%) and to slow to 6.5% (from 6.2%) in 2018. The upward revision to the 2017 forecast reflects stronger than expected performance in the first half of the year underpinned by policy support and reforms. The upward revision to the 2018 forecast is driven by an expectation that the authorities will maintain a sufficiently expansionary policy mix through high public investment to meet their target of doubling real GDP by 2020. Headline inflation in China is expected to be 2.3% in 2017 and rise to 2.4% in 2018.

Figure 2: Growth Projection in the Advanced Economies

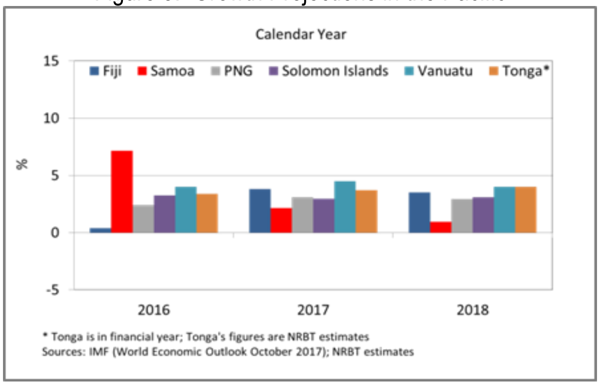


Japan's GDP increased by 4% in annualized terms for the year ended June 2017. This was driven by strong consumer spending and business investment also expanded significantly. As such, the IMF October 2017 WEO projected growth for 2017 to be 1.5% for 2017 (upgrade from 1.2%) and 0.7% in 2018 (upgrade from 0.6%). Furthermore, the growth momentum is expected to be driven by strengthening of global demand and policy actions to sustain a supportive fiscal stance. However, in the medium term, the pace of expansion is expected to moderate following 2018 with the assumed fading of fiscal support and slower projected growth in foreign demand offsetting the boost from 2020 Olympics-related private investment. Headline inflation is expected to increase to 0.1% in 2017 after being slightly negative in 2016. This is supported by higher energy prices. However, the gradual rise projected for inflation is still expected to remain subdued and below the Bank of Japan's target of 2% throughout the forecast horizon.

South Pacific Economies

The South Pacific region showed an average GDP growth of about 2.9% since the February 2017 MPS over the year to August 2017. Growth in respective economies are expected to remain moderate whilst inflation is expected to continue to rise driven by the recovery in crude oil prices and the appreciating US dollar, which is the intervention currency. Amongst the South Pacific economies, the Reserve Bank of Fiji noted in its October 2017 economic review, that Fiji's economic growth is projected to be revised upward in 2017 driven largely by growth in public administration & defense, manufacturing, construction, wholesale & retail trade and finance & insurance sectors.

Figure 3: Growth Projections in the Pacific



The Central Bank of Samoa reported in its MPS for 2016/17 that the economy is expecting strong growth for 2017/18 to be driven by the strong performances in Fishing, Construction, Commerce, Transport and Accommodation and restaurant sectors. The Bank of Papua New Guinea estimated high economic growth for 2017/18 as a result of increasing mining activities and improvements in international prices for some export commodities. Additionally, the hosting of the Asia-Pacific Economic Cooperation (APEC) meetings would also support economic growth in 2018.

Table 1: World Data (Real GDP Growth, Inflation, and Unemployment)

	Real GDP growth (%)			Inflation (%)			Unemployment* (%)		
	2016	2017f	2018f	2016	2017f	2018f	2016	2017f	2018f
World Growth	3.2	3.6	3.7						
Australia	2.5	2.2	2.9	1.4	2.0	2.3	5.7	5.6	5.4
China	6.7	6.8	6.5	2.1	2.3	2.4	4.0	4.0	4.0
Euro Area	1.8	2.1	1.9	1.1	1.1	1.6	10.0	9.2	8.7
Japan	1.0	1.5	0.7	0.3	0.1	0.6	3.1	2.9	2.9
New Zealand	3.6	3.5	3.0	1.3	2.4	2.0	5.1	4.9	4.6
United States	1.5	2.2	2.3	2.2	1.8	2.3	4.9	4.4	4.1

Note: f – forecast

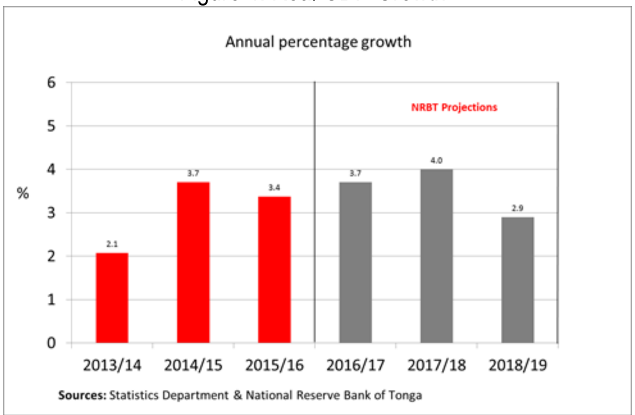
Source: IMF (World Economic Outlook, October 2017), NRBT

2. Tonga's Economic Growth

Real GDP Growth

The Reserve Bank's outlook for a stronger real GDP growth of 3.7% in 2016/17 remains. This follows the 3.4% real GDP growth in 2015/16 estimated by the Statistics Department. The 3.7% growth forecast is higher than the 2.7% growth projected by the IMF Article IV mission in September 2017. This growth outlook continues to be driven by developments in the construction, utilities, fisheries, and mining & quarry sectors. The number of events that took place during the year has contributed to this overall growth forecast and partial indicators showing improvement in economic activities in 2016/17, support this overall strong growth projection.

Figure 4: Real GDP Growth



The annual real GDP growth forecast for 2017/18 has been revised downward to 4.0% from 4.8% anticipated in the February 2017 MPS. However, this is still above the 2017 IMF Article IV's projection of 3.4% growth. This downward revision to the growth outlook is mainly driven by the cancellation of Tonga's hosting of the 2019 Pacific Games which will slow down growth that was projected for the secondary and tertiary sectors of the economy.

The Reserve Bank's growth outlook for 2018/19 remained unchanged at 2.9%, which almost similar to the IMF's 3.0% growth projection. This projected decline in growth from the previous year is due mainly to the anticipated completion of major construction projects in 2017/18 such as the Faua Wharf and other major transportation projects. The financial intermediation, construction, transport & communication, and utilities sectors are expected to drive growth in 2018/19.

Primary Production

Following a 2.5% growth in 2015/16, the primary sector of the economy is expected to grow by 2.9% in 2016/17 mainly driven by the agricultural and fishing sectors.

The agricultural sector is anticipated to have grown by 2.5% in 2016/17 compared to a 0.3% growth in 2015/16. This stronger growth was supported by favorable weather during the year which resulted in an increase in both domestic production and export volume. Over the year to June 2017, the total volume of agricultural exports increased by 2,875.9 tonnes (33.0%) to a total 11,529.7 tonnes. This was supported by better harvest of root crops, the favourable squash, watermelon, and breadfruit season. Cassava exports contributed largely to this rise with a total export volume increasing by 2,142.1 tonnes (146.4%), followed by a 788.7 tonnes (85.2%) increase in exported yam. The favorable squash season in late 2016 led to a rise in total exported squash by 344.9 tonnes (9.2%).

In addition, reports from the domestic agricultural market conveyed that crops sold domestically rose by 3,580.4 tonnes (141.2%). Similar to the export volume, cassava remained the crop with the highest volume available for domestic purchase. Other food such as fruits and vegetables particularly for watermelon, pineapple, and cabbages also increased significantly over the year.

Figure 5: Volumes of Major Exported Agricultural Exports

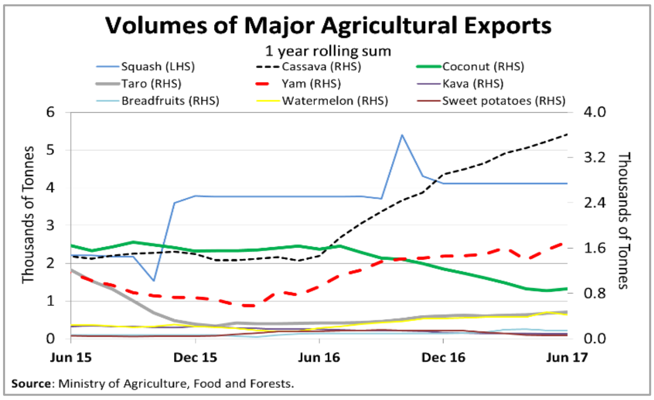


Table 2: Real GDP Growth Forecast

	Official 2014/15	Preliminary 2015/16	FY 2016/17 (Feb- 17 MPS) %	FY 2016/17 (Revised) %	FY 2017/18 (Feb-17 MPS) %	FY 2017/18 (Revised) %	FY 2018/19 (Feb-17 MPS) %	FY 2018/19 (Revised) %
GDP	3.7	3.4	3.7	3.7	4.8	4.0	2.9	2.9
Primary production	**-2.7**	**2.1**	**2.9**	**2.9**	**2.6**	**2.6**	**2.1**	**2.1**
Agriculture	-4.8	0.3	2.5	2.5	2.0	2.0	1.8	1.8
Forestry	16.8	-20.2	0.1	0.1	0.1	0.1	0.1	0.1
Fishing	7.4	15.6	5.4	5.4	5.7	5.7	3.5	3.5
Secondary production	**10.9**	**7.8**	**4.9**	**4.9**	**9.7**	**7.7**	**4.1**	**4.1**
Mining and quarrying	9.1	6.0	5.2	5.2	10.0	7.5	4.0	4.0
Manufacturing	4.2	1.3	3.8	3.8	6.0	5.0	2.8	2.8
Utilities	2.1	8.3	3.8	3.8	7.0	5.5	4.0	4.0
Construction	20.2	12.7	6.0	6.0	13.0	10.0	5.0	5.0
Tertiary production	**2.7**	**3.7**	**3.5**	**3.5**	**3.8**	**3.1**	**2.8**	**2.8**
Trade	4.3	2.7	5.4	5.4	6.5	4.5	3.8	3.8
Hotels, restaurants	7.7	7.2	4.7	4.7	3.0	2.6	2.8	2.0
Transport, communication	12.4	5.3	5.8	5.8	5.0	3.5	4.1	4.1
Financial intermediation	-3.9	12.6	6.6	6.6	7.0	7.0	6.5	6.5
Real estate, business services	6.4	7.2	1.5	1.5	2.0	2.0	2.0	2.0
Public administration	1.7	0.4	0.7	0.7	1.0	1.0	1.0	1.0
Education	-2.8	-3.1	2.0	2.0	2.0	2.0	2.0	2.0
Health and social work	-7.9	8.6	1.5	1.5	1.5	1.5	1.5	1.5
Recreational, cultural activities	6.7	5.1	2.0	2.0	3.0	3.0	2.0	2.0
Other community services	-6.3	6.7	2.0	2.0	2.0	2.0	1.5	1.5
Ownership of dwellings	1.0	1.8	2.0	2.0	3.0	3.0	1.0	1.0
Other*	6.5	4.6	1.0	1.0	1.0	1.0	1.0	1.0

* Includes taxes minus subsidies and imputed bank service charges
Source: Department of Statistics, NRBT

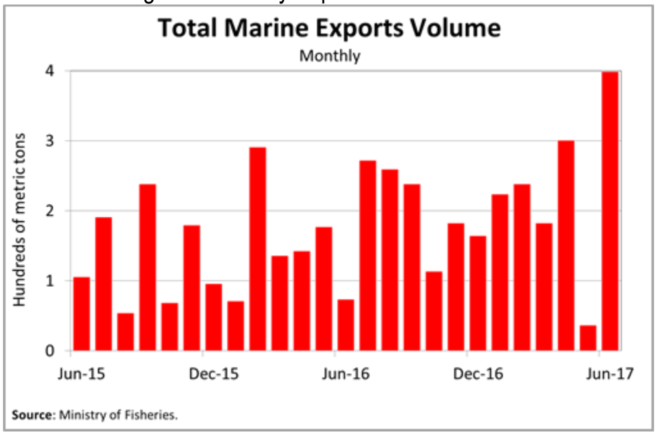
Loans to the agricultural sector contributed to the improved growth during 2016/17. The Government Development Loan (GDL) facilitated by Tonga Development Bank contributed to the rise in loans to the agricultural sector by $2.3 million (27.5%) to a total of $27.5 million in the year ended June 2017.

Agricultural export proceeds reported by the banking system increased by $4.7 million (76.1%) to $10.9 million in 2016/17. The higher export receipts were for squash and crops (root crops and traditional crops), supported by the strengthening of the Japanese Yen and US dollar against the Tongan Pa'anga.

The performance in the agricultural sector is expected to slow to 2.0% in 2017/18, following two consecutive years of strong growth. The continuous support from the MAFF and continuous active growth committees such as Growers Federation and Hahake Growers assist the development in this sector. The agricultural exporters aim to improve infrastructure for farmers such as the packing house facilities. The re-opening of the High Temperature Forced Air (HTFA) facility would support the exports of papaya, breadfruit, and the new products to be introduced such as eggplant and chilies. It is projected that the favourable squash season will continue in 2017/18. The GDL scheme also supported the growth in the agricultural sector by providing affordable finance to the growers and agricultural exporters. However, the greatest risk to the outlook of this sector is the uncertainty in the weather conditions and the sustainability of lands and crops.

The growth projected for the fisheries sector remains positive. This is supported by a rise in marine exports (excluding aquarium products) over the year to June 2017 by 891.6 metric tons (51.9%). A significant increase in exports of tuna by 840.8 metric tons (54.9%) over the year to June 2017 drove the higher exports in 2016/17. Exports of snapper also rose by 62.7 metric tons (66.2%). The increase in the number of fishing vessels may have contributed to the overall rise in marine exports. The exports of fisheries and other marine products brought in $8.7 million in proceeds over the year to June 2017 as reported by the banking system, rising by $1.5 million (21.5%) compared to 2015/16.

Figure 6: Fishery Exports



The outlook for the fisheries sector remains positive, given the different initiatives by the Ministry of Fisheries and other incentives to improve the sector. This sector continued to benefit from the tax concessions on oil and fishing gear. This is supported by the Ministry of Fisheries' Sector Plan, which included key principals to develop the Special Management Areas program, particularly on coastal and commercial fisheries and also the economic development of commercial fisheries and aquaculture. The duty exemptions policy on oil and fishing gear and the initiatives of Fisheries Development and Export Fund (FDEF) by the Government through its GDL scheme assisted the access to finance of fishermen which is reflected in more fishing boats and the increased volume of fish available in the local market and exported overseas as indicated by exporters through the Reserve Bank's liaison program. In addition, Tonga has qualified to participate in piloting fisheries projects in Timaru, New Zealand which will provide opportunities to the sector. Furthermore, the mabe pearl industry operating in Ha'apai will contribute to the overall growth of the Ministry's export proceeds as the Ministry of Fisheries reported that "the mabe pearl industry shows a great potential to prove income and livelihood benefits for the communities of Ha'apai". Nonetheless, weather uncertainties still remain a risk to this sector.

A rebound of 0.1% growth is forecasted for the forestry sector in 2016/17 compared to a negative 20.2% in the previous year, and a similar growth is projected for 2017/18. According to liaisons with Tonga Power Limited, major network upgrade projects in Tongatapu scheduled for 2017/18 may increase the demand for poles supplied by Aotearoa-Tonga Forest Product Limited, hence contribute to the sector growth.

The competition from overseas firms may pose a risk to this forecast. A two year contract signed by A-TFP with Samoa will contribute to a possible positive growth in the sector. MAFF also has initiatives to revive the sandalwood market to further contribute to the sector in the long term.

Secondary Production

The secondary sector is estimated to record a 4.9% growth in 2016/17 supported by the on-going construction works as indicated by the increase in individual housing loan and business lending for construction sector. This will also benefit other sectors in the secondary production. The developments in the construction sector are expected to have spillover effects on mining and quarrying activities, manufacturing, utilities sector and other sectors of the economy.

The construction sector is projected to grow by 6.0% in 2016/17, same projection as reported in the February 2017 MPS. The anticipated growth is supported by an increase in business loans for construction, manufacturing, and utilities and also a rise in housing loans. Business loans for the secondary sector rose by $4.0 million (14.5%) whilst individual housing loans rose by $41.0 million (31.7%). Projects completed during the year such as the renovation of the Tanoa International Dateline Hotel, church buildings, St. George Palace, and LDS chapels contributed to the 2016/17 growth. It is estimated that new building applications received by the Ministry of Infrastructure in 2016/17 rose by $4.0 million (14.6%) to a total of $31.5 million compared to 2015/16.

The outlook for the construction sector remains positive despite the cancellation of the 2019 Pacific Games. New offices and construction such as the major upgrade and extension of Faua wharf, a new office building for the Utilities sector, construction of sports facilities and various other private construction works are expected to drive growth in the upcoming years.

According to liaison with the Ministry of Infrastructure, there are also major public and private construction projects already in the pipeline. A large part of these projects are the construction of sports facilities such as the Tonga High School (THS) Sports Complex, upgrade of the Teufaiva Stadium, relocation of Tonga Side School and other projects. These sports facilities have been confirmed to proceed although there might be a delay in the timing of construction. Private constructions also included an increase in accommodation business, and construction by returning residents, mostly retirees.

Developments in the mining & quarrying sector are expected to be in line with the projected vibrant construction sector.

The utilities sector is projected to grow by 3.8% in 2016/17 supported by the increase in electricity consumption by 5.94 million kW over the year to June 2017. This coincided with a 6.24 million kW rise in electricity production and 859 rise in the number of electricity consumers in the year ended June 2017. Given the expected developments in the construction sector, the utilities sector is also forecasted to grow further by 5.5% in 2017/18 before slowing to 4.0% in 2018/19.

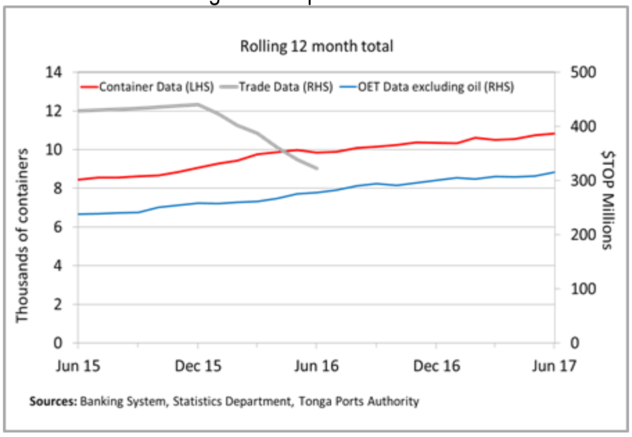
The manufacturing sector is expected to grow by 3.8% in 2016/17 and a stronger 5.0% growth is expected for 2017/18. This is supported by the rise in business loans to the manufacturing sector by $4.4 million (28.8%) in year ended June 2017, the increase in trade indicators and expected rise in consumption.

Tertiary Production

The growth projected for the tertiary production in 2016/17 is lower than 2015/16, however the trade, transport & communication are expected to record stronger growth compared to the previous year. This slowed growth is due to lower growth in the financial intermediation, real estate and business services sectors.

During 2016/17, the number of registered containers rose by 987 registrations (10.0%). Both private and business containers rose with private containers increasing the most by 905 registrations (21.3%). The events and celebrations held during the year, and the increase in private constructions supported this annual growth. Additionally, the number of registered vehicles rose by 672 registrations (22.1%) over the year to June 2017. The easy access for online trading of second hand cars and increased demand for new vehicles by the returning Recognized Seasonal Employees (RSE) workers from overseas supported this growth. Moreover, the trade sector benefitted from a $0.9 million (1.5%) rise in banks' lending to households (housing loans excluded) over the year.

Figure 7: Import Indicators



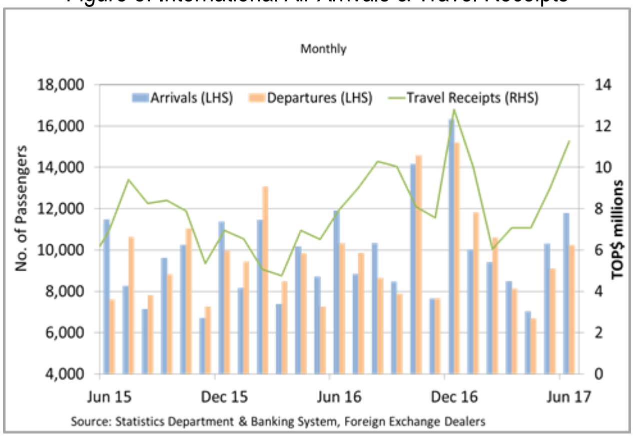
The Reserve Bank expects imports and consequently container registrations to generally increase in the near term. The Reserve Bank's liaisons with the construction and transport sectors had indicated growing demand in these sectors which will also drive imports in the near future. On-going construction projects and new private residential constructions are anticipated to contribute to the rise. Spillover effects on the trade, tourism, construction sectors and other sectors in the economy are also anticipated.

The transport and communication sector of the economy are expected to grow further in 2016/17 by 5.8% compared to the 5.3% growth reported by the Statistics Department for 2015/16. The improvement in the transport sectors stems from the new road constructions under the Climate Change Resilience Project. Additionally, the Ministry of Infrastructure has conveyed through the Reserve Bank's liaison program that the transportation sector is the Ministry's current priority. Furthermore, a newly introduced telecommunication company is expected to contribute to growth in the communication sector.

Tourism activities are estimated to remain vibrant in 2016/17 supported by the events that took place during the year. Over the year to June 2017, international visitors arrivals continued to rise by 9,192 passengers (11.9%), driven mainly by a rise of 8,236 passengers (45.3%) in cruise ship arrivals, as a total of 16 ships arrived during the period compared to 14 cruise ships in the previous year. The number of returning residents also rose by 2,521 passengers (7.4%). Growth in the tourism sector is consistent with a $24.2 million (28.8%) rise in travel receipts. The Reserve Bank remains optimistic that the tourism sector will continue to remain vibrant in 2017/2018 and the upcoming years.

Activities in the financial intermediation sector remained strong, supported by continued high credit growth in 2016/17. The increasing activity in this sector was sustained by the low interest rate environment and the ongoing competition among banks. The Reserve Bank's monetary policy to encourage the utilisation of the excess liquidity in the banking system to support economic activity supports the outlook for strong lending growth.

Figure 8: International Air Arrivals & Travel Receipts



Unemployment

According to the Tonga 2016 Census of Population and Housing report released by the Statistics Department, the unemployment rate was recorded at 16.4%[2] against a 6.5% unemployment reported in the February 2017 MPS. The measurement method had changed hence the significant change in the unemployment rate estimation. A total of 6,650 people at the age 15 and older were categorized as unemployed. According to the Reserve Bank's survey of job advertisements, total

[2] The definition of unemployment was reviewed by the Statistics Department to "not working, available and willing to work". The previous definition used was "not working, available, looking for work & discouraged workers".

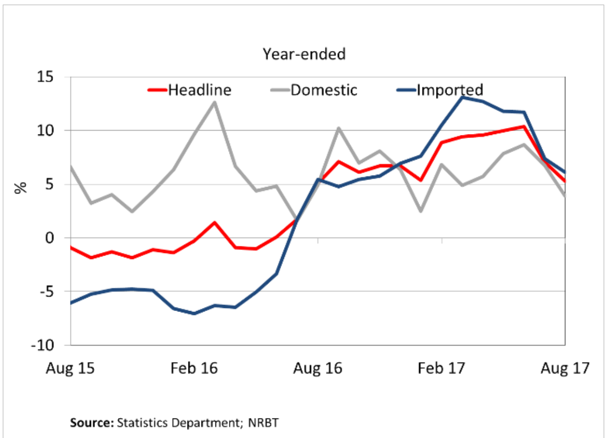
job advertisements declined over the year to June 2017 by 25 advertisements (7.9%). However, the Reserve Bank's analysis of job advertisements suggests that recruitment intentions during the year were noted mainly in the services sectors. This was in particular to public administration, hotels & restaurants, and transport & communication sectors. Increased demand for labour is anticipated in line with the Reserve Bank's outlook for strong economic growth in the medium term supporting a lower unemployment rate.

3. Promoting Low and Stable Inflation

Recent Developments

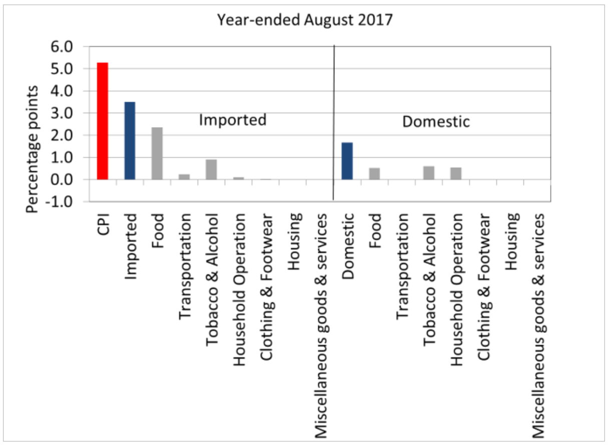
Inflationary pressures eased in August 2017 reflecting the wind down of the hike in prices last year when the new excise tax imposed on various goods became effective in July 2016. However, a revision to excise tax and custom duty was implemented in July 2017 for some certain goods which may have contributed to maintaining the August inflation at a high level.

Figure 9: Inflation



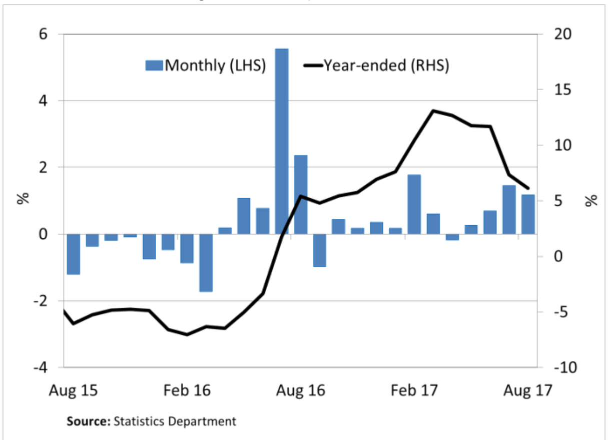
Over the past six months to August 2017, annual headline inflation remained high but it edged lower to 5.2% in August 2017 from a high of 8.9% in February 2017, a high of 10.3% in June 2017, but remained slightly higher than 5.1% in August 2016. The imported and local food prices remained the main contributors to the overall annual headline inflation in August, which contributed 2.9 percentage points.

Figure 10: Contributions to Inflation



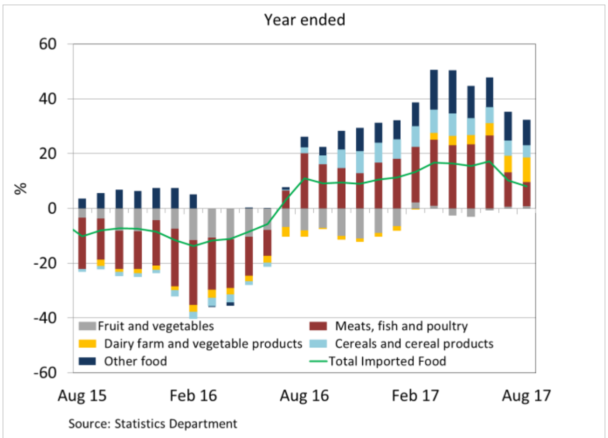
The annual imported inflation increased by 6.2% over the year to August 2017, which accounted for 3.5 percentage points of the overall headline inflation. This was mainly driven by higher food, tobacco and oil prices. Imported food remained the largest contributor which rose by 8.1%, contributing 2.4 percentage points to the overall headline inflation.

Figure 11: Imported Inflation



The prices of all imported food categories rose over the year to August 2017, led by a 9.3% increase in the prices of other food components reflecting a rise of 11.4% in the price of sugar. This was followed by a 9.0% rise in the prices of dairy farm and vegetable products for goods such as butter and cheese. The price of meat, fish and poultry increased by 8.8% which included goods such as lamb flap whose price rose by 16.3%.

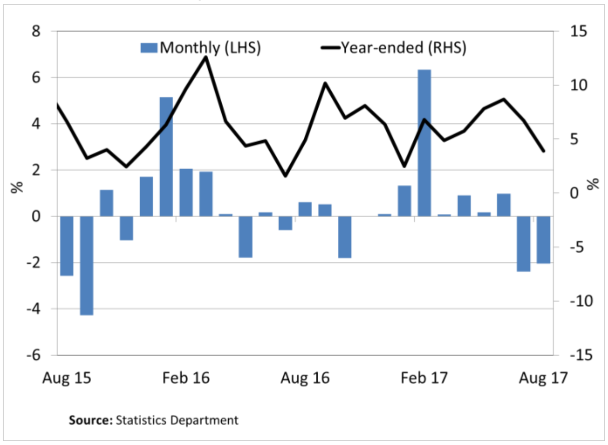
Figure 12: Imported Food



In addition, the price of the tobacco, alcohol and kava category rose by 18.5%, contributing 0.9 percentage points to the annual headline inflation. The main driver for this category was tobacco which comprised of Winfield blue whose price rose over the year by 23.2%. Furthermore, the 5.1% increase in world oil prices drove the price of fuel higher with a lag of 1–2 months, contributing 0.2 percentage points to the annual headline inflation. The Brent crude oil was US$50.82 per barrel in August 2017 compared to US$48.37 per barrel in August 2016. This was reflected in the increase in price of petrol and diesel over the year of 3.9% and 2.2% respectively. The revised excise tax introduced in July 2017 and the strengthening of the

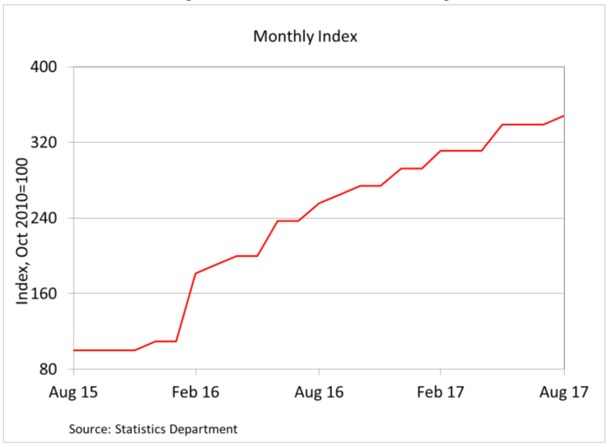
USD, AUD, and NZD against the TOP contributed to the higher imported prices.

Figure 13: Domestic Inflation



Domestic inflation also rose over the year to August 2017 by 3.9% which accounted for 1.7 percentage points of the headline inflation. The continued short supply of kava-Tonga, seasonality of local food and rise in electricity price drove the domestic inflation higher. The price of local kava increased by 36.2%, contributing 0.6 percentage points to the overall headline inflation. According to the Reserve Bank's liaison program, the prolonged dry weather in the past years continued to affect the supply of kava-Tonga.

Figure 14: Price of kava-Tonga



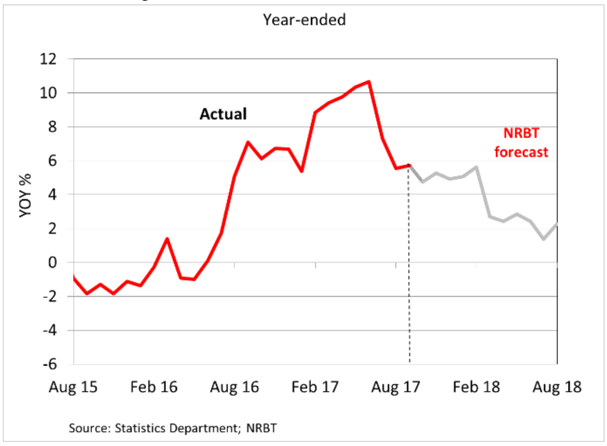
Additionally, the price of local food rose by 2.7% contributing 0.5 percentage points to the overall headline inflation. The prices of various local produce increased over the year particularly on prices for tuna, lū, pineapple, stringed fish, cockles, sweet potatoes and talo-Tonga. The seasonality and the increased demand for these food types during the year contributed to the higher prices.

The increase in oil prices drove the electricity price higher by 12.6%, contributing 0.5 percentage points to the overall headline inflation.

Outlook

The Reserve Bank expects the upward inflationary pressure to remain in the near term due mainly to the impact of the revised custom duty and excise tax effective in July 2017. However, the annual headline inflation is forecasted to gradually decline below the reference rate of 5% per annum after February 2018. The movements in global food and oil prices may pose a risk to this outlook. Additionally, the vulnerability of Tonga to natural disasters and uncertain weather conditions pose a risk to the local food prices and consequently the inflation outlook. The Reserve Bank will closely monitor the sources of higher inflation which include assessing the effects of exchange rates, new tax introduced and also the businesses' profit margins.

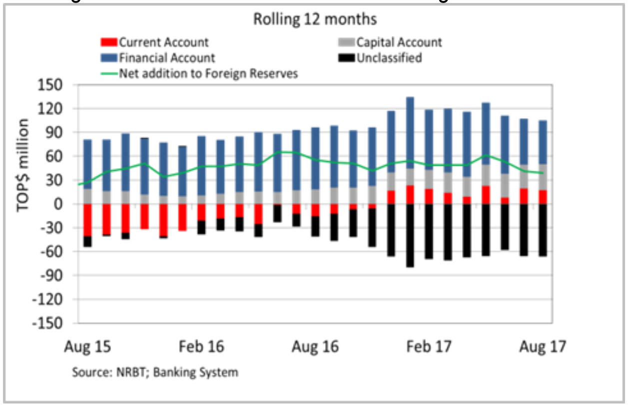
Figure 15: Headline Inflation Forecast



4. Maintaining Adequate Level of Foreign Reserves

The Reserve Bank continued to closely monitor the country's external monetary position in its function to maintain an adequate level of foreign reserves above 3-4 months of import cover. The following data and estimates of the balance of payments are based on the OET data collected by the Reserve Bank from the banks and authorized restricted Foreign Exchange Dealers (FEDs).

Figure 16: Balance of Overseas Exchange Transactions



Balance of Overseas Exchange Transactions

Over the past six months to August 2017, the overall balance of OET was a surplus of $27.4 million, which contributed to a rise in the official foreign reserves to $405.0 million. This was more than double the surplus recorded for the past six months to February 2017 of $11.4 million and was mainly attributed to surpluses in the current, capital and financial accounts.

In year ended August 2017, the overall balance also recorded a surplus of $38.9 million, which was lower than the surplus $55.4 million over the year to August 2016. The capital account surplus over the year continued to drive the annual overall surplus.

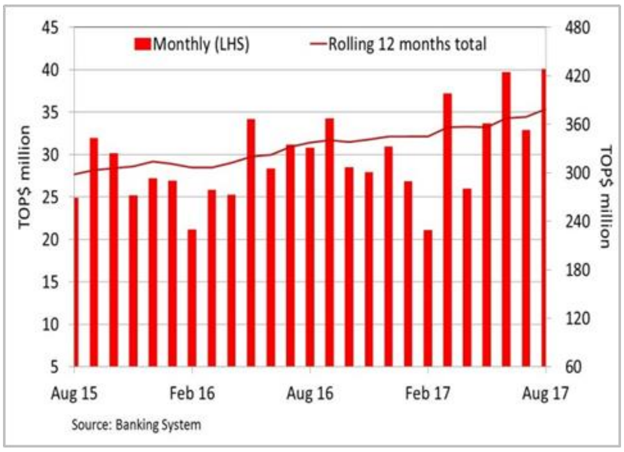
Current Account

The surplus in the current account over the last six months to August 2017 dropped by $15.0 million to a surplus of $1.3 million from $16.3 million in the last six months to February 2017. This was largely attributed to higher trade deficit recorded over the previous six months.

Over the year to August 2017, the current account balance recorded a surplus of $17.6 million compared to a deficit of $16.0 million in the same period of the previous year. The higher transfers particularly private transfers and service receipts offset the higher trade deficit and together with the increased primary income payments drove the surplus in the current account.

Majority of the current account payments over the past six months to August 2017 were import payments totaling to $209.4 million, which were 23.6% higher than it was in the six months to February 2017. The higher import payments over the past 6 months were due mainly to higher payments for import of oil which rose by $22.9 million. Other imported goods, mostly the Government's imports, rose by $11.2 million and the import of wholesale & retail goods increased by $8.5 million. This was in line with the 5.5% increase in container registrations and also supported by the events that took place during these months such as the church conferences and family celebrations. On the other hand, payments for the import of vehicles and construction materials decreased over the past six months to August 2017 which is in line with the 0.8% decrease in vehicle registrations.

Figure 17: Import Payments

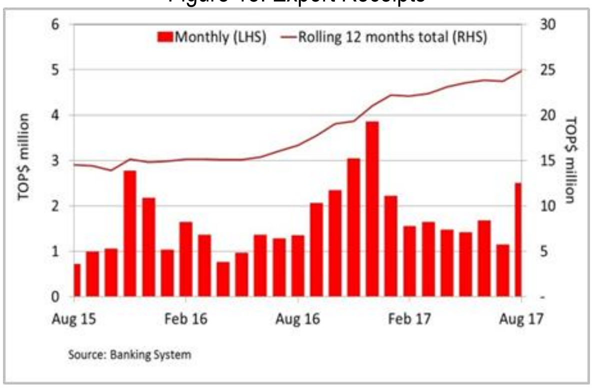


Over the year, import payments rose by 12.1% to $378.8 million, due mainly to rise in payments for all categories of imports. Import payments for wholesale and retail goods increased the most by $88.5 million, followed by an $11.5 million rise in payments of construction materials. Payments for oil imports rose by $9.6 million, government import payments increased by $6.4 million and payments for imported motor vehicles grew by $5.6 million. Higher payments for the import of wholesale and retail goods were consistent with a 12.1% rise in container registrations and supported by the improved growth in the distribution sector. Additionally, the removal of custom duty on construction materials and easier access to online trading facilities, increased competition with the local car dealers and higher demand for cars from individuals including the rising number of RSE workers contributed to the higher imports of construction goods and second hand motor vehicles.

In the six months to August 2017, total export proceeds declined by 34.6% to $9.8 million. This was mainly attributed to lower proceeds from the export of agricultural products, which fell by $6.4 million due to slowdown in agricultural exports following the completion of the harvesting season of squash in the previous six months. Marine and other export receipts both decreased by $0.3 million each.

For the 12-month period ended August 2017, total export proceeds rose by $8.2 million (49.1%) to $24.9 million. This was attributed mainly to an increase in the proceeds for agricultural exports of $5.0 million (78.4%) and other exports of $3.1 million (178.1%). This is consistent with the stronger growth in the agricultural sector, as reflected in the increase in the volume of agricultural exports by 1.9 million tonnes over the year. The more favorable weather conditions may have contributed to the improvement in export receipts.

Figure 18: Export Receipts

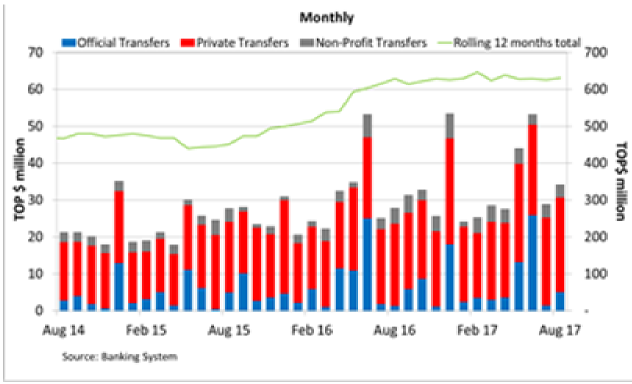


Transfer receipts played a major role in the performance of the current account. Over the six months to August 2017, transfer receipts rose by $23.8 million. This resulted from an increase in both the private and official transfers by $13.0 million (10.1%) and $12.6 million (32.1%) respectively. This was partially offset by a decline in non-profit transfers by $1.9 million. Receipts for family support however drove the rise in private transfer receipts whereas the rise in official transfer receipts resulted from higher inflows of budgetary support and government grants during the period. The decline in non-profit transfer receipts were mainly due to decline in grants received by non-profit organizations mostly churches and schools for technical assistance and other current expenditure.

In year ended terms, total transfer receipts rose by 18.3% to $409.2 million. All categories of transfers rose over the year with private transfer receipts increasing the most by 15.3% to $270.7 million.

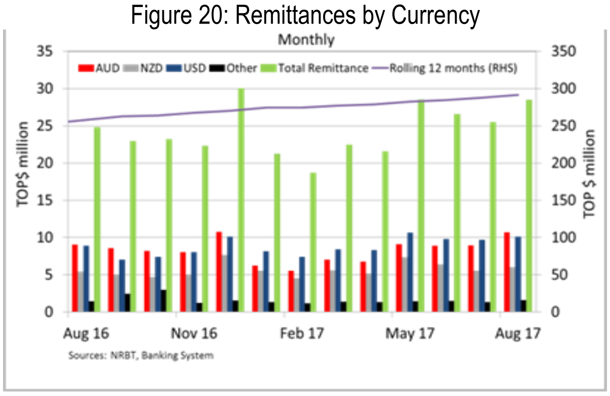
Total private transfer receipts in the six months period to August 2017 was at $141.9 million which accounted

Figure 19: Transfer Receipts



for 65.5% of the total transfer receipts. Total private transfers accounted for 92.8% of the total remittance receipts during the same period. Total remittances consisted of the private transfers, receipts from compensation of employees (seasonal employees and other wages and salaries), and private capital transfers by individuals and social benefits. Despite the de-risking decisions which has resulted in the closing of some of the authorized restricted foreign exchange dealers' bank accounts, total remittances continued to rise over the six months to August 2017 by 10.6% to $152.9 million and over the year by 13.0% to $291.1 million. Total remittances over the year represented 38% of the total OET receipts. This was largely driven by the continued transfer of funds from families and friends abroad to support their families in country, as well as the major celebrations throughout the year such as the school anniversaries' celebration (Tonga High School & Mailefihi Siu'ilikutapu College), family reunions, and the churches' annual conferences. It is estimated that remittances as a share of GDP for 2016/17 was 34.0%, rising from 33.1% in the previous year.

Figure 20: Remittances by Currency



There was a surplus of $26.8 million in the services balance recorded for the six months ended to August 2017, which was attributed mainly to higher travel receipts. In year ended terms, the surplus in services of $38.6 million more than doubled the previous year's surplus. This was mainly due to higher travel receipts during the year compared to the previous year.

Capital Account

Capital account receipts over the past six months to August 2017 rose by $5.6 million to $20.5 million. This was attributed to receipt of foreign aid by the Government for capital investments, particularly receipts for Government construction projects such as the upgrading of the new domestic wharf, St George Palace, and the new hospital for Niuatoputapu. Capital payments, on the other hand, declined by $2.4 million to $0.2 million, driven by lower private capital payments for investment and projects or capital expenditures. Therefore, the capital account balance recorded a surplus of $20.3 million over the six months to August 2017.

Over the year to August 2017, the capital account balance was a surplus of $32.6 million, 76.0% higher than the surplus for the year ended August 2016. This was attributed to higher government receipts for investment projects and capital expenditures compared to the previous year.

Financial Account

Financial account receipts declined over the six months to August 2017 by 30.3% to $39.2 million, due to lower inflows of foreign direct and other investments. Similarly, financial account payments slightly declined by 0.6% to $20.3 million which were mostly in the form of direct investment. Thus, the financial account balance was a surplus of $18.8 million over the six months period ended August 2017, which was $16.9 million lower than the surplus in the 6 months to February 2017.

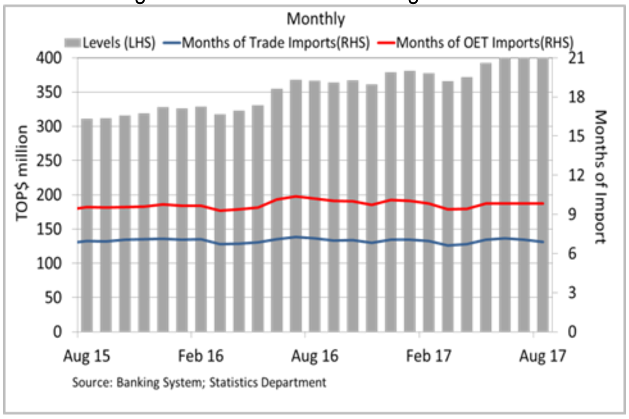
For the 12-month period ended August 2017, the financial account balance recorded a surplus of $54.6 million, a decline of $22.9 million (29.6%) from the surplus of $77.5 million in the year ended August 2016, reflecting a decline in foreign direct investment.

The balance of unclassified transactions recorded an average outflow of $5.5 million per month over the 12 months to August 2017, compared to $2.1 million in the previous year. This was due to higher financial claims by non-residents which involves foreign exchange dealings between commercial banks and their overseas correspondent banks.

Official Foreign Reserves

Gross official foreign reserves continued to rise to another record high of $405.0 million in August 2017, compared to $377.7 million in February 2017. This was sufficient to cover 6.9 months of import of merchandise goods and services[3], which remained above the Reserve Bank's minimum range of 3-4 months of import. In year ended terms, gross official foreign reserves rose by $38.8 million. The increase over the year was due mainly to higher remittance receipts, higher receipt of foreign aid from donor partners and budgetary support for the Government.

Figure 20: Gross Official Foreign Reserves



Exchange Rates

The Nominal Effective Exchange Rate (NEER) index rose by 0.3% over the six months to August 2017 as the TOP appreciated against the USD and NZD. The Real Effective Exchange Rate (REER) index also rose over the same period by 0.8% reflecting the impact of Tonga's higher inflation relative to its major trading partners. Over the year, both the NEER and the REER index rose by 1.4% and 4.9% respectively which may disadvantage the recipients of foreign currency.

Outlook

The Reserve Bank expects the level of foreign reserves to remain comfortably above the minimum range of 3-4 months of import up to June 2018 based on the following key factors:

- Remittances are expected to remain at high levels over the coming months due to upcoming festivities and scheduled events for 2018 such as the annual church conferences. Rising number of people joining the RSE schemes also contributes to expectation of higher remittance receipts.
- Expected growth in agricultural and fisheries activities is expected to boost export proceeds and

[3] Method of calculation has changed in February 2017 to include both imports of goods & services (previous method used imports of goods only)

this will be offset by the projected rise in import payments.

- Banks and foreign exchange dealers expanding their range of products and services offered to customers will also support remittances and other financial receipts.
- Tourism activities such as whale watching, proceeds from artisanal handicrafts, sea cruises, more airline routes, new hotels and restaurants are expected to support positive travel receipts.
- Government receipt of aid funds in the form of budget support and other assistance from donor partners are expected in the next financial year for on-going construction projects.

Risks to the outlook of the foreign reserves include the following:

- Delays to the inflow of aid and budget support from development partners combined with the pace of development in domestic economic activities pose a risk to the foreign reserves outlook.
- The significant rise in external debt service to Export - Import (EXIM) Bank of China as the principal repayment of the loan commences in financial year 2018/19.
- Vulnerability to natural disasters which can significantly impact export and travel receipts.
- Uncertainty in the forecast of world fuel and commodity prices can harm Tonga's external position as a price taker.

5. Promoting a Stable Financial System

Over the 6 months to August 2017, the banking system continued to remain sound. A strong capital position was maintained supported by banks' comfortable profitability, high liquidity remained, and non-performing loans continued to remain low. Steady growth in total lending continued, which reached a million (18.9%) increase in deposits particularly savings and term deposits.

Despite the rise in Statutory Required Deposit ratio from 5% to 10% in July 2017, liquidity in the banking system (reserve money) increased over the last 6 months to August 2017 by $4.9 million (1.8%) to a

Table 3: Consolidated Balance Sheet of Depository Corporations

	Level			YoY change	
	Aug 16	Feb 17	Aug 17	Aug 16	
	$TOPm	$TOPm	$TOPm	$TOPm	%
Broad money liabilities	**491.0**	**510.2**	**552.3**	**61.3**	**12.5**
Currency in circulation	48.4	50.9	60.7	12.3	25.3
Demand deposits	197.3	200.7	200.0	2.7	1.4
Savings and Term deposits*	245.2	258.6	291.6	46.4	18.9
Equals					
Net foreign assets	**377.9**	**402.2**	**429.0**	**51.1**	**13.5**
Plus					
Net domestic assets	**113.4**	**108.3**	**123.4**	**10.0**	**8.8**
Gross bank lending**	364.1	394.6	427.0	62.9	17.3
Other***	-250.7	-286.4	-303.6	-52.8	21.1

* Also includes very minor amounts for securities other than shares.
** Differs slightly from standard measures of bank lending by amounts classified as accrued interest.
*** Includes mostly capital accounts of the banks and NRBT, and their net claims on the central government.
Note: Figures may not be exactly the same as in the text below and table above due to rounding errors.
Sources: Banking system; NRBT

new record high in August 2017. Growth in deposits climbed to new heights as well, coinciding with the high level of foreign reserves. The weighted average interest rate spread narrowed slightly over the period.

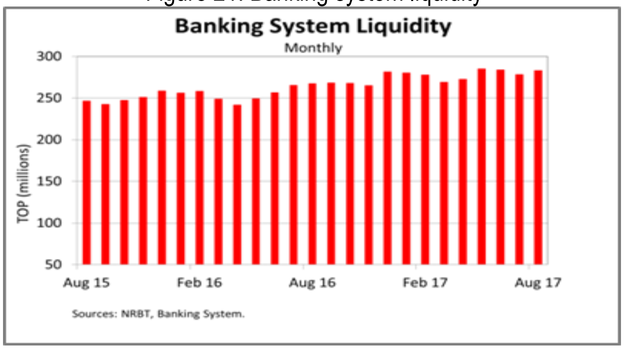
Money Supply

Broad money rose over the last 6 months to August 2017 by $42.1 million (8.3%) to a record high of $552.3 million compared to $510.2 million in February 2017. This was driven by a $26.8 million increase in net foreign assets and a $15.2 million rise in net domestic assets. Higher foreign reserves continued to drive the rise in net foreign assets while an increase in credit to the private sector contributed to the increase in net domestic assets.

Over the year to August 2017, broad money increased by $61.3 million (12.5%). This was driven by respective increases in both net foreign assets and net domestic assets of $51.1 million (13.5%) and $10.0 million (8.8%). This is the highest annual growth recorded for net foreign assets which is attributed to the continued increase in the level of foreign reserves. Additionally, this coincided with the $12.3 million (25.3%) increase in currency in circulation and $46.4

$282.9 million, higher than the level of $278.0 million reported in the February 2017 MPS. Additionally, throughout the last 6 months, liquidity in the banking system hit a new high of $284.8 million in May 2017. Higher deposits over the past 6 months further supported the growth in reserve money. Similarly, liquidity in the banking system increased over the year to August 2017 by $15.7 million (5.9%) driven by growth in currency in circulation and deposits.

Figure 21: Banking system liquidity



The banks' total loans to deposit ratio rose in August 2017 to 75.2% from 73.3% in February 2017, due to a credit growth of $31.1 million outweighing a $28.1 million increase in deposits, and improved from 73.7% in August 2016. This ratio continued to remain below the 80% loan to deposit ratio target which indicates excess liquidity in the banking system remains and that there is capacity for further lending by banks. The Reserve Bank will continue to monitor the lending growth to avoid any overheating in the economy.

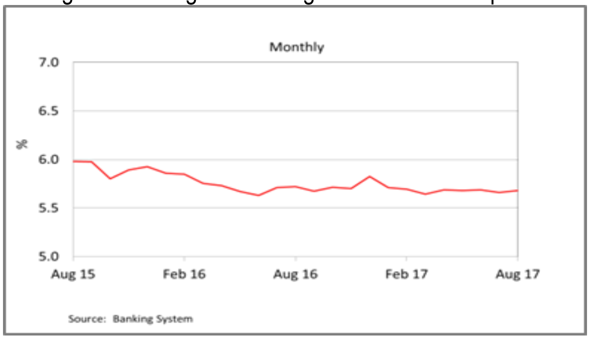
The Reserve Bank continued its efforts to improve the quality of banknotes and coins in circulation and at the same time meet public demand and the commercial banks' demand for certain denomination of banknotes and coins. This was done through outreach work with respective churches to exchange higher denomination notes held by the churches with lower denomination notes given the quality of lower denomination notes are most needed to be improved. Furthermore, the Reserve Bank's Currency Department continued to direct deposits of mint quality notes to the Reserve Bank's note trust depots in the outer islands by interchanging and replacing mutilated notes with good quality notes on a timely manner.

Interest Rates

The weighted average lending rate decreased by 2.8 basis points (from 7.86% to 7.83%) which outweighed the decrease in the weighted average deposit rate by 1.2 basis points (from 2.16% to 2.15%) over the past 6 months to August 2017. As a result, the banks' weighted average interest rate spread narrowed marginally by 1.5 basis points to 5.68% from 5.70% in February 2017. The weighted average lending rate declined over the past 6 months due to lower business lending rates for the manufacturing, distribution, and tourism sectors. The weighted average deposit rate declined due to lower demand and term deposit rates.

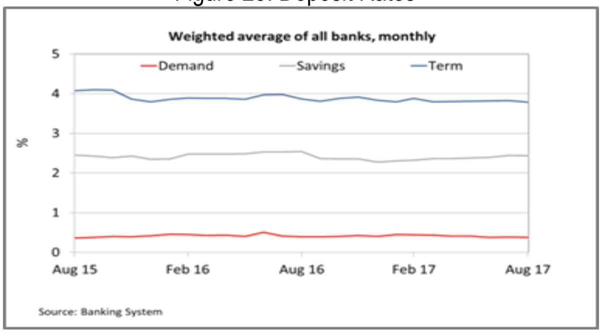
Over the year, the weighted average lending rate declined by 7.4 basis points whilst the weighted average deposit rate declined by 3.3 basis points. Consequently, the weighted average interest rate spread narrowed by 4.1 basis points. The weighted average lending rate's decrease was due to lower lending rates for both households and businesses. Lending rates for vehicle loans and other personal loans led the decline in lending rates for households. Meanwhile, lower lending rates for the manufacturing, fisheries, and tourism sectors drove the lower lending rates for businesses. Furthermore, the low interest rates on Government Development Loans (GDL) facilitated by the Tonga Development Bank contributed to the lower weighted average lending rates particularly for the manufacturing, fisheries and tourism sectors.

Figure 22: Weighted Average Interest Rates Spread



The weighted average deposit rate declined over the year driven by decreases in the interest rates for all deposit categories. The saving deposit rates declined the most by 10.8 basis points followed by term deposit rates and demand deposit rates. This was further supported by a continuous rise in foreign reserves as well as the high level of total deposits which continued to increase over the past 6 months to August 2017 recording a high level of $552.4 million.

Figure 23: Deposit Rates



Lending

Total banks' lending increased over the past 6 months to August 2017 as well as over the year to a new high level of $415.6 million. Total loans increased by $31.1 million (8.1%) from February 2017, which was higher

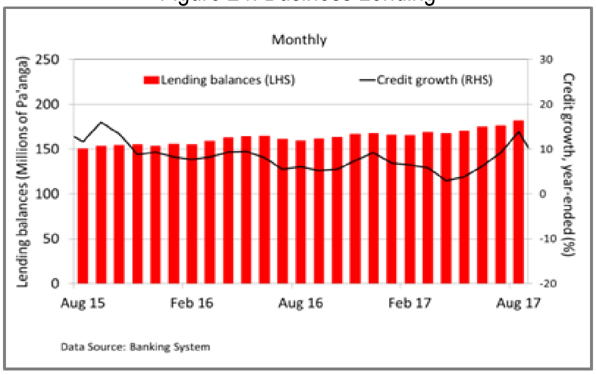
Table 4: Lending Rates
Weighted average of all banks

	Level as at			Change over 6 months to		Loan share	
	Aug 17 %p.a.	Feb 17 %p.a.	Aug 16 %p.a.	Aug 17 Bps	Feb 17 Bps	Aug 17 %	Feb 17 %
All	7.83	7.86	7.90	- 2.8	- 4.6	100	100
Housing	8.10	8.01	8.08	9.4	- 7.1	43	43
Other personal	10.97	10.97	11.00	0.5	- 3.2	15	16
Business*	6.82	6.90	6.94	- 8.4	- 3.8	30	26
Other	6.54	6.25	6.54	28.9	- 28.6	12	15

*Included Statutory Non-financial Corporation and Other Financial Corporations than the $29.3 million (8.2%) rise in the 6 months to February 2017. The significant growth in total lending was due mainly to the growth in business loans of $16.3 million (9.9%) and household loans rose by $14.7 million (6.7%). Only 2.2% of total loans were funded from the GDL as at the end of August 2017, decreasing from 2.6% in February 2017.

Banks' lending to businesses increased over the past 6 months to $181.8 million, higher than the level of $165.5 million in February 2017. This was largely a result of higher lending to the wholesale & retail, services, manufacturing, and agriculture sectors. This continued to reflect growing economic activities within the private sector. This further indicates preparation by the country for various events such as festivals, pageants, church conferences, and other on-going developments over the six months to August 2017. The private sector continued to expand through renovations and extensions of their buildings or businesses. This includes the Kongakava Boutique Hotel, Friends Café, Kupu House, and new Cost Low Warehouse which are all anticipated to be opened in the next few months. The decrease in the weighted average lending rate over the past 6 months supported the higher level of lending to businesses. Low interest rates on GDL further supported higher lending to business sectors.

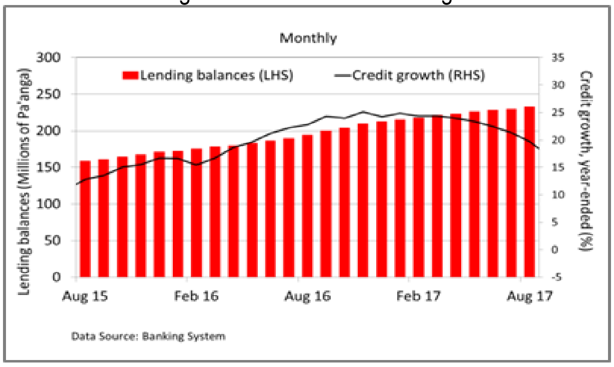
Figure 24: Business Lending



The higher level of lending to households was driven by more loans for housing and other personal purposes. This continued to indicate consistent household demand for housing and other consumption items. Over the 6 months to August 2017, housing loans significantly led banks' lending to households to a new high level of $232.6 million, compared to $217.9million recorded in February 2017. Housing loans increased by $13.5 million (8.5%). Despite the weighted average lending rate for individual housing loans increasing by 9.4 basis points, demand by households for loans was higher and unaffected. Other household personal loans increased by $1.3 million (2.3%), which reflected high consumer demand due to cultural activities, events, and the festive season that occurred throughout the past 6 months. Vehicle loans however decreased over the 6 months to August 2017 by $0.1 million (10.4%) compared to the $0.3 million (46.3%) increase over the 6 months to February 2017.

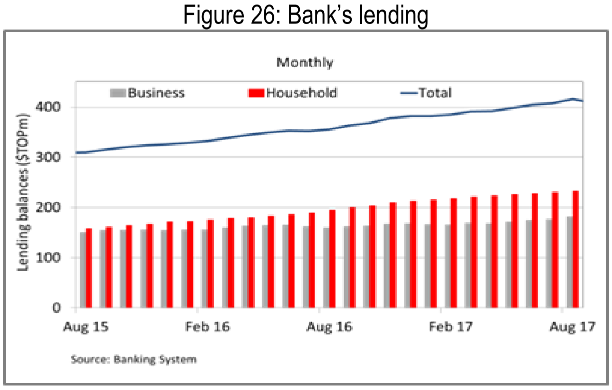
New business loan commitments fell over the 6 months to August 2017 by $7.3 million (33.7%) to $14.3 million driven by a decrease in new loan commitments to mainly wholesale & retail and construction sectors.

Figure 25: Household Lending



Over the year, total bank lending increased by $60.4 million (17.0%) which was significantly driven by both increases in household and business loans. Household and business loans rose by $38.3 million (19.7%) and $22.2 million (13.9%) respectively. The increase in household lending over the year was a result of increases in all household lending categories particularly housing loans increasing the most by $34.8 million (25.4%).

Figure 26: Bank's lending

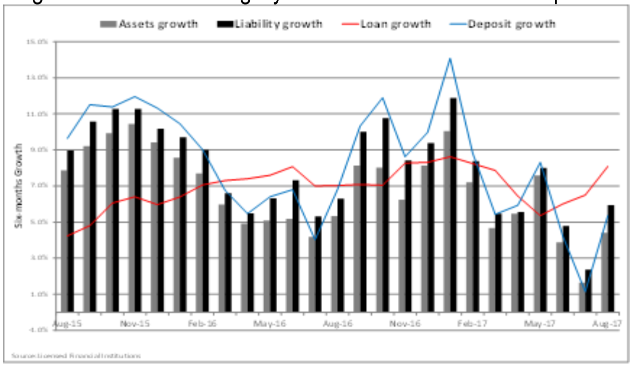


Business loans increased driven by higher lending to the wholesale & retail, transport, manufacturing, and agriculture sectors. The growing activities in these sectors were partially supported by the lower interest rates from the GDL scheme. Lending activities of the non-bank financial institutions[4] also increased over the year by $18.2 million (14.5%). This was driven by an increase in household loans of $18.9 million (25.9%) offsetting a fall in non-bank financial institutions' business loans.

Banking System Performance

The banking system remained sound during the six months to August 2017. Total assets of the banking system increased by $33.1 million (4.4%) to $787.2 million over the six months to August 2017. This was due mainly to an 8.1% ($31.1 million) growth in total loans. Similarly, total liabilities increased by 5.9% ($35.8 million) to $640 million which is largely attributed to a 5.4% ($28.1 million) growth in total deposits over the past six months to August 2017. This was followed by an increase in Other Miscellaneous Liabilities of $6.9 million (23.7%) mainly due to rise in bank cheques that are to be settled and provision for tax in June 2017.

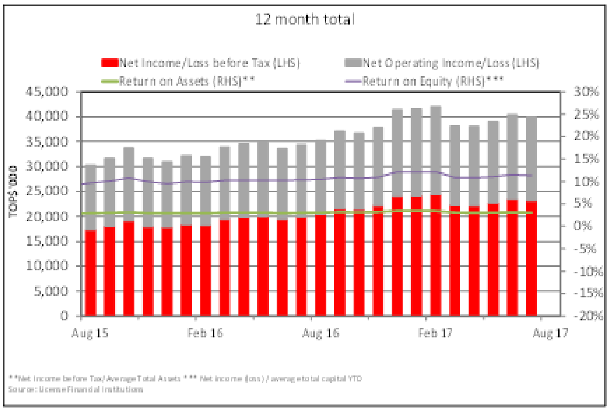
Figure 27: Total Banking System Balance Sheet Development



The total banking system remained profitable over the year to August 2017. The Net Profit After Tax was $23.1 million, falling from $25.1 million in February 2017, but was higher than $22.6 million in August last year.

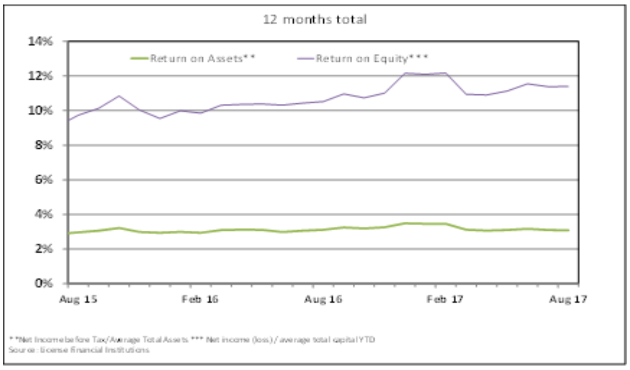
Both the Return on Assets (ROA) and the Return on Equity (ROE) slightly decreased over the past six months. The ROA was 3.1% and the ROE was 12.2%, both decreasing from 3.6% and 12.7% respectively in February 2017. The lower profitability over the past six months to August 2017 was due mainly to higher outsourcing and depreciation expenses.

Figure 28: Total Banking System's Profitability



The banking system's capital position remained strong as the risk-weighted capital ratio was at 27.9% in August 2017, which fell from 33.8% in February 2017, but remained well above the Reserve Bank's minimum requirement of 15%. The lower risk weighted capital ratio reflected banks repatriating their retained earnings back to Head Office as a result of a successful financial year in 2016. The banks' net interest margin remains the same as reported in August 2016.

Figure 29: Total Banking System's ROE & ROA

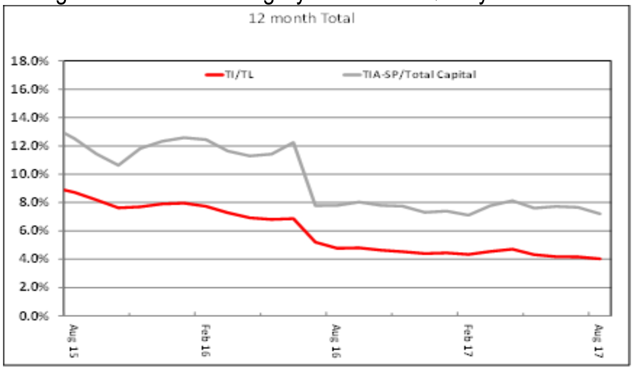


The overall quality of the banks' assets has remained relatively stable over the past six months to August 2017 at $16.8 million. Total non-performing loans represented 4.0% of total loans compared to 4.3% February 2017 and 4.8% a year ago.

The large portion of non-performing private business loans grew to 56.6% from 52.4% six months ago and comprised mainly of loans for Tourism, Professional and other services, Construction, and Agriculture.

[4] This includes SPBD, RFB & Government on-lent loans

Figure 30: Total Banking System Asset Quality Indicators



Non-performing private individual loans accounted for 43.4% of total performing loans, lower than the 47.6% recorded in February 2017. This was attributed to a fall in personal loans of $1 million as some loans were being recovered while some were written off. Provisions against loan losses rose over the past six months by $1 million but rose by only $0.5 million over the year to $15.4 million. The total coverage ratio which shows the capability of the banks' total provisions to cover non-performing loans rose to 91.6% from 88.2% last year. The value of collateral held against the delinquent loans reported by banks was at $20 million compared to total non-performing loans of just $16.7 million. This indicated that banks hold sufficient collateral to cover for any shortfall in loan loss provisions.

The Reserve Bank continued to monitor and manage the payment system to ensure it is functioning in an efficient, sound and safe manner. There is ongoing review of options and opportunity to explore an automated payment system that will assist in improving the efficiency of the settlement of banks' transactions.

Outlook

The Reserve Bank's credit growth forecast for 2017/18 remains at 15% as published in the February 2017 Monetary Policy Statements (MPS), which is lower than the IMF Article IV projection of 16.6% for 2017/18. The Reserve Bank's policy measure that was effective on 1st July 2016 which set a minimum requirement on banks' loans/deposit ratios to encourage further lending, supports the anticipated continued growth in credit and broad money. At the same time, structural reforms to improve the credit environment such as improvement to the land administrative system and a bankruptcy law would improve the confidence of the banks to lend prudently. Work is in progress to establish and supervise a credit bureau in country to support the credit environment. The banks' outlook for credit growth remains positive and the Reserve Bank's projection is supported by the continuous improvements in business confidence, improving economic conditions and ongoing annual events. Non-performing loans is also likely to decline in the near future.

Broad money is also projected to increase in June 2018 by 14%, as previously projected, supported by the anticipated rise in lending and the foreign reserves. This is higher than the IMF Article IV's projection for broad money to rise by 12.1% in June 2018.

Supervision of Non-Bank Financial Institutions (NBFIs)

The development of the legal and regulatory framework for the licencing and supervision of all non-bank financial institutions remains work in progress. The legislations for the supervision of moneylenders, credit union, microfinance institutions and foreign exchange dealers have been approved by Cabinet and are being processed to be submitted to the Legislative Assembly. Regulating NBFIs is essential in order to ensure financial stability is maintained and that the customers of these NBFIs are better informed of the risks associated with the NBFIs' products and that their interests are protected. This includes concerns with high interest rates charged by the informal lenders. The Reserve Bank recognizes that regulation of NBFIs should be to a relatively lesser extent compared to bank supervision, as they are serving certain sectors of the economy or community that are not serviced by the banks. In addition to maintaining financial stability, the regulation of systemically important non-bank financial institutions such as insurance companies, retirement funds and microfinance institutions are important to minimize potential systemic risks. The licensing and supervision of foreign exchange dealers continue under the current Foreign Exchange Control Regulations, which are being amended to improve the Reserve Banks regulatory powers. The draft Financial Consumer Protection policy is being finalized to enhance the protection of financial consumers and thereby maintain confidence in the financial system. Work is also in progress to update the stock take of all the

NBFIs operating in Tonga while awaiting the approval of the legislations.

Financial Inclusion Initiatives

In February 2017, the Reserve Bank's mandate under section 4 of the National Reserve Bank of Tonga Act was extended to include promoting financial inclusion, as it recognizes that this supports its role of ensuring inclusive economic growth and macroeconomic stability, and that financial inclusion is not just about the availability and sustainability of financial services in the remote areas, but also the affordability and relevance of these services to the livelihood of the people of Tonga.

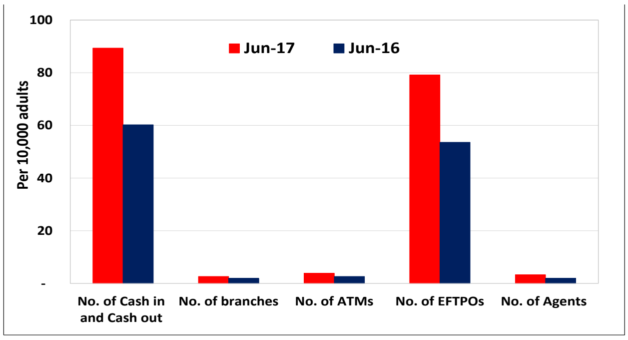
The Reserve Bank has engaged with relevant national and international stakeholders over the past six months in developing the financial inclusion framework that would promote access to finance. Coordinated efforts are being acknowledged and buy-in of important stakeholders such as Government officials and the private sector is crucial for the success of the financial inclusion initiatives. This includes the drafting of a Micro, Small and Medium Enterprises (MSMEs) policy framework with the ultimate objective to improve access to finance for MSMEs. This would be achieved by creating an enabling environment to facilitate the development of appropriate financial products and services that would meet the needs of the MSMEs. A number of challenges have been identified to date, which includes the lack of data or statistics on MSMEs and their access to finance. The Reserve Bank recognized the importance of statistics in order to measure the baseline level of access of finance and thereon track the progress with promoting MSMEs' access to finance.

The Reserve Bank recently released its report on Demand Side Survey (DSS) that was conducted in 2016 in partnership with the Tonga Department of Statistics together with the assistance of the Pacific Financial Inclusion Programme (PFIP) and the Bankable Frontier Associates (BFA). This nationally representative survey covered randomly selected households across Tonga from the urban, rural and remote areas including the outer islands. The purpose of the survey was to diagnose the state of financial inclusion in Tonga, identify the challenges and barriers that are faced by Tongan people with regards to accessing financial products and services, the type of products and services that are in demand as well as the level of awareness and financial literacy of the people. The main findings of the report were:

- ✓ Tonga's level of financial inclusion is comparable with the rest of the Pacific region, particularly Samoa.
- ✓ 34% of Tongan adults are completely excluded from financial services, with another 14% only accessing informal financial service instruments such as savings clubs, shop credit, moneylenders, or hire purchases. Only 41% of Tongan adults have a bank account. Those more likely to be financially excluded are low-income earners, casual income-earners and most of the residents of Ha'apai.
- ✓ Unlike other Pacific Island countries, there is no apparent gender gap in bank account ownership, and neither does age appear to be a factor for account ownership.
- ✓ Financial transactions are heavily cash-based, with the majority of Tongan adults (with the exception of the public sector) receiving income in cash. Nearly all Tongans pay utility and school payments with cash instead of using digital channels such as bank transfers, debit cards or mobile money.
- ✓ Tongans rely heavily on informal savings and credit, with 46% of Tongan adults saving at home and 23% using savings clubs.
- ✓ Remittances are an important income source for many Tongan adults, with 70% reported receiving remittances in the last year.
- ✓ 63% reported saving geared towards everyday expenses and social obligations, rather than saving for long term goals such as housing, business, asset accumulation or education.
- ✓ Many Tongans do not feel the need for insurance coverage.

As a member of the Alliance for Financial Inclusion (AFI), the Reserve Bank adopted the AFI core set of indicators to measure the level of financial inclusion in Tonga. Data collected by the Reserve Bank shows that access to financial services has improved over the year to June 2017 with all core set of indicators increasing. The number of bank branches, ATMs and bank agents per 10,000 adults increased over the year resulted in increasing deposit accounts, percentage of administrative units with at least one access point and the overall number of access points per 10,000 adults at a national level.

Figure 31: Tonga's Access Points Indicators



The number of branches per 10,000 adults improved over the year to June 2017 mainly due to BSP re-opening branches that were closed by Westpac Bank in the outer islands in 2014. Similarly, the number of ATMs, agents and the number of EFTPOS per 10,000 adults increased mainly driven by increases in Bank South Pacific's ATMs and EFTPOS machines. There were no major changes in the other banks' access points over the year. Total number of regulated deposit accounts per 10,000 adults rose by 12%. This was driven by increases in the number of demand deposits, which is consistent with the Demand Side Survey's findings that individual savings are geared towards short term goals.

According to the IMF Financial Access Survey 2017, Tonga leads in financial access points particularly in bank branches compared to the rest of the Pacific Island countries. Thanks to BSP Tonga for the re-opening their Bank branches in Haapai and Eua. Looking ahead, the number of access points is likely to increase for Tonga. Banks are planning to increase the number of ATMs and agent banking as well as piloting digital products for remittances and are considering mobile tablets services in the future.

6. Fiscal Indicators

The fiscal position has improved over the 6 months to August 2017. Banking system data shows the net credit to government continued to fall by $17.2 million (18.2%) over the 6 months to August 2017, compared to a $28.6 million (43.2%) decline in the 6 months to February 2017. This was due to an increase in government deposits, which reflected higher government receipts during the past 6 months to August 2017. The receipt of the budgetary support, grant funds before the end of 2016/17 fiscal year, as well as improved government revenue collections largely contributed to this increase.

The improved government revenue collection is consistent with the rise in the number of containers by 301 registrations (5.5%) over the past 6 months. The enforcement of the amended custom duties and excise taxes on 1st July 2017 may have also contributed to the higher revenue collected since July 2017.

Over the year to August 2017, net credit to government also decreased by $45.8 million (94.8 %), due to a $44.8 million (48.1%) rise in government deposits. This was largely driven by the receipt of budgetary support funds before the end of the 2016/17 fiscal year. The 2017/18 Government Budget indicated a Government Finance Statistics (GFS) fiscal balance of $13.4 million of net borrowing compared with $3.9 million in 2016/17. This is projected to be financed by foreign liabilities of $28.6 million, of which the majority are foreign loans of $26.6 million and the remaining $1.9 million are domestic bonds. The higher borrowing requirement reflects the significantly higher principal repayments for 2017/18 and in the medium term. Additionally, these borrowings are to fund the construction projects such as the on-going sports development facilities and to support funding the government expenditures budgeted for the 2017/18 fiscal year. The government also expects to issue government bonds to support the GDL scheme administered by the Tonga Development Bank. .

Total receipts of $34.4 million of budget support funds are also anticipated to be received in 2017/18 from development partners, however none has been received to date. Majority of the budget support funds are expected to be received from the Asian Development Bank and the World Bank. Nevertheless, a $4.7 million of budget support funds from the European Union (EU) was received in August 2017. This is a portion of the delayed budgetary support of $6.0 million from the EU that was budgeted for 2016/17. This contributed to the higher foreign reserves over the past 6 months to August 2017. The budget support funds estimated for 2017/18 is expected to be received before the end of the 2017/18 fiscal year.

Tonga maintained its debt rating at moderate risk of external debt distress. The external debt continued to rise, which resulted from 50% of the grants received from World Bank and Asian Development Bank during the year being deemed credit. The total public debt position for June 2018 is expected to represent 54.1% of GDP, of which 47.8% is external debt and 6.3% is domestic debt. This is consistent with one of the three fiscal targets in the Government of Tonga Fiscal Strategy for 2017/18, which is to maintain the external debt below 50% of GDP. The other two targets are to raise domestic revenue collections to at least 22% of GDP and to maintain the compensation of employees at no more than 53% of domestic revenues and moving towards 50% over time. The total debt service for 2017/18 is estimated to remain at over $20 million where majority of this debt service is to finance the external loan repayments. External debt service is estimated by the Reserve Bank to remain at over $10 million for the next fiscal year, and then expected to rise significantly to over $27 million in 2018/19 due to the first principal repayment for the Nuku'alofa Central Business District Reconstruction loan due in September 2018, followed by the commencement of principal repayment for the Tonga National Road Improvement Project loan in March 2020, both to EXIM Bank of China. The main repayment months for external debt are September and March of every year due to repayment of two major loans to EXIM Bank of China. The EXIM Bank of China remained the main external debt creditor and hence the Chinese Renminbi has the highest share of the total external debt portfolio. This significant increase in external debt service to EXIM Bank of China in 2018/19 is anticipated to put pressure on the level of foreign reserves.

In the 2017/18 Government Budget, new number of revenue policy reforms initiated and became effective on 1st July 2017, with the purpose of promoting an efficient tax regime and widened revenue base. This included the amendments to the excise rates on alcohol and tobacco goods in addressing observed hike in road accidents and death toll. In addition, migration of NCD related goods from import dutiable goods to excise taxable goods in order to reduce consumption of unhealthy products and promote healthy lifestyle. A new PAYE Tax System also included implementing in 2017/18 to increase equity and fairness in tax administration along with standard benchmark of a progressive tax regime. Furthermore, import tariff on a number of construction materials especially the electrical goods were revised to be zero-rated.

On the outlook, the government receipts is expected to rise in the near term due to the budget support that are yet to be received in 2017/18. This would contribute to the Reserve Bank's projection for foreign reserves to remain at comfortable levels to June 2018. Additionally, the implementation of amendments to the customs duty and excise tax, the new Pay As You Earn (PAYE) Tax System, other related service fees and the expected strong economic activity may also contribute to the increase in government revenue collection.

Net credit to the government is also anticipated to decline as a result of expected government budgetary support and grants receipts, as well as improved government collection. However, this will be partially offset by the projected expenditure in the government's 2017/18 budget statement, released in June 2017. The Reserve Bank will closely monitor the implication of the fiscal policy measures on the monetary policy objectives.

7. Monetary Policy Stance

The Reserve Bank maintained its current monetary policy stance. Despite the increase in the annual inflation rate in August 2017, the foreign reserves remained at comfortable levels above the minimum range of 3 – 4 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 favorable growth as projected.

The Reserve Bank's outlook for strong domestic economic activity remains in the medium term. The level of foreign reserves is also expected to remain at comfortable levels supported by expected higher receipts of remittances and foreign aid and this will be partially offset by the projected rise in imports.

The annual headline inflation rate is anticipated to fall below the Reserve Bank's inflation reference rate of 5% per annum after February 2018. It is also projected that the foreign reserves will remain comfortably above the minimum range of 3 – 4 months of import cover. The stability of the financial system was maintained with no signs of overheating despite the strong credit growth over the year.

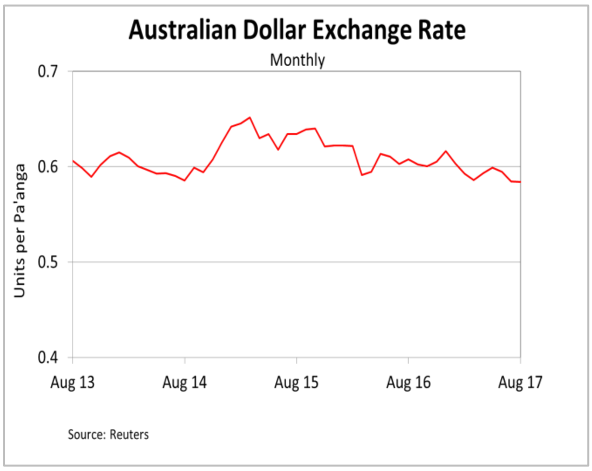
Excess liquidity in the banking system still remained as the continuous increase in deposits, coinciding with the higher foreign reserves, outweighed the strong credit growth. The banks' loans/deposit ratio remained below the 80% loan to deposit target. The excess liquidity in the system therefore continues to weaken the monetary policy transmission mechanism.

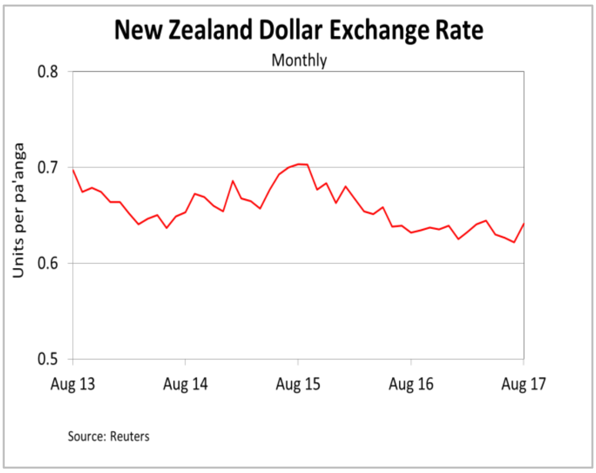
Given the recent developments and the outlook on the monetary policy targets, the current monetary policy stance is considered appropriate in the medium term. Therefore, the Reserve Bank will continue to adopt measures, as outlined below, to encourage the utilisation of the excess liquidity in the banking system to increase lending in order to support domestic economic growth, and strengthen the monetary policy transmission mechanism in the medium term.

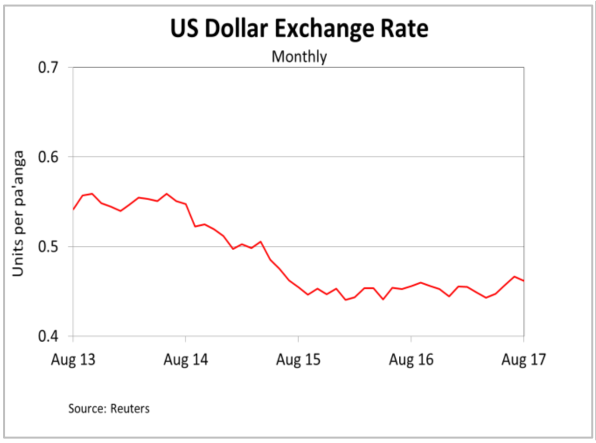
- ✓ Maintain the monetary policy rate (interest rate on banks' exchange settlement accounts or excess reserves) at 0% (zero interest rate policy);
- ✓ Maintain the minimum loans/deposit ratio at 80%;
- ✓ Maintain the Statutory Reserve Deposit ratio at 10%;
- ✓ Maintain the inflation reference rate at 5%;
- ✓ Continue to closely monitor the effects of the eased Foreign Exchange Control requirements and economic development on the foreign reserves;
- ✓ Consider using open market operation (such as the issuance of NRBT notes) to mop up the excess liquidity in the system and assist in developing the domestic market;
- ✓ 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;
- ✓ Continue 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.

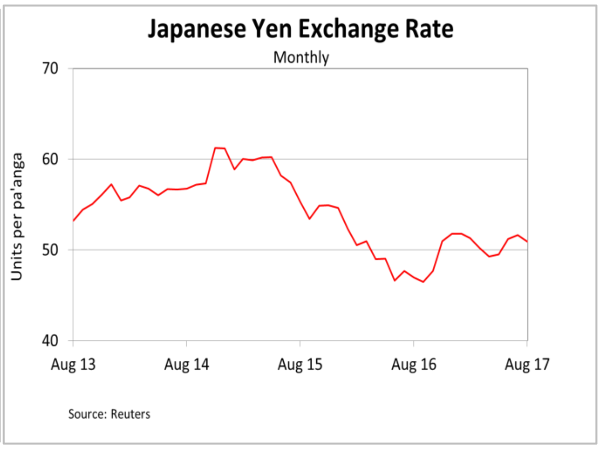
The Reserve Bank will remain vigilant and continue to closely monitor early signs of vulnerability, developments in the domestic and global economy, and update its monetary policy setting to maintain internal and external monetary stability, and to promote a sound and efficient financial system in order to support macroeconomic stability and economic growth.

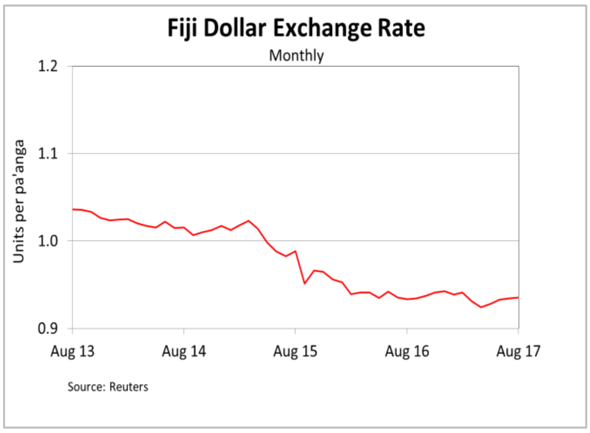
Appendix 1: Tongan Pa'anga Exchange Rates

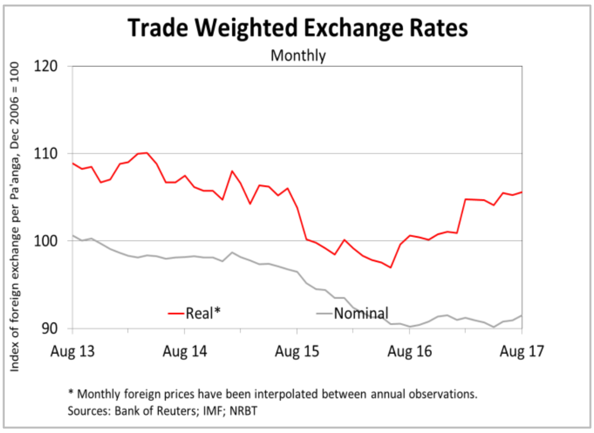












Appendix 2: Monetary Policy Objectives

The NRBT's obligations with respect to monetary policy are laid out in Section 4(1) of the National Reserve Bank of Tonga (Amendment) Act 2014, which state that the principal objectives of the Bank shall be to:

1) Maintain internal and external monetary stability.
2) without prejudice to its principal objective, the Bank shall-
   (a) promote financial stability, and
   (b) Promote a sound and efficient financial system.
3) Subject to subsections (1) and (2), the Bank shall conduct its activities in a manner that supports macroeconomic stability and economic growth.

In addition, Section 30(2) of the NRBT (Amendment) Act, states the Bank shall exclusively hold and manage the official international reserves of the Kingdom and maintaining an adequate level of foreign exchange reserves.

Under the Act, the NRBT shall maintain internal and external monetary stability through maintaining official foreign exchange reserves and promoting price stability.

Maintaining an adequate level of foreign reserves is vital for a small open economy such as Tonga. It is dependent on imports for the supply of most of its goods, which needs to be paid for in foreign currency. Given Tonga's vulnerability to external shocks and natural disasters, its small size, narrow export base, and dependence on imports, it is imperative that foreign reserves are maintained at an adequate level to meet individuals' needs for basic essentials and support economic growth.

An adequate level of foreign reserves also minimizes volatility in the exchange rate and provides confidence that businesses and individuals in Tonga are able to meet their foreign currency obligations. The Reserve Bank targets a level of foreign reserves equivalent to 3 to 4 months of imports.

Imported goods account for 58% of the CPI basket, so changes in the prices of imported goods and the exchange rate have a significant influence on the overall level of domestic prices.

Price stability contributes to economic welfare and sustainable economic development. Price stability also contributes to better economic performance. When inflation is low and stable it is easier for people to distinguish changes in relative prices and to adjust their decisions regarding consumption, saving, and investment accordingly. Importantly, an environment of stable prices also reduces risk in long-term financial agreements, as lenders and investors will be less likely to demand a high inflation risk premium to compensate for the loss of purchasing power. This reduces the costs to borrowers and increases the incentives for businesses to invest.

The high proportion of Tonga's exports and imports as a share of production means that domestic prices are likely to move closely with the prices of traded goods, which in turn depend closely on the value of the exchange rate. Vulnerability to external shocks, such as oil price increases, adverse weather conditions, and high dependence on remittances and imports, heighten the importance of promoting external stability, exchange rate stability and therefore overall price stability.

By promoting external stability through maintaining an adequate level of foreign reserves and promoting price stability, the NRBT through its conduct of monetary policy can most effectively contribute towards macroeconomic stability, sustained economic growth and raise prosperity for Tonga.