

# NATIONAL RESERVE BANK OF TONGA

Monetary Policy Statement  
August 2016

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## List of abbreviations

AFI	Alliance for Financial Inclusion
AML/CFT	Anti-Money Laundering/Counter Terrorist Financing
AUD	Australian Dollar
BSP	Bank South Pacific
DFAT	Department of Foreign Affairs and Trade
EXIM	Export-Import
EU	European Union
FEC	Foreign Exchange Control
FEDs	Foreign Exchange Dealers
GDP	Gross Domestic Product
GNP	Gross National Disposable
GPF	Global Policy Forum
HTFA	High Temperature Forced Air
IDH	International Dateline Hotel
IFAD	International Fund for Agricultural Development
IMF	International Monetary Fund
JPY	Japanese Yen
LDS	Latter Day Saints
LNG	Liquefied Natural Gas
MAFF	Ministry of Agriculture, Food & Forests
MFAT	Ministry of Foreign Affairs and Trade
MPS	Monetary Policy Statement
NBFIs	Non-Bank Financial Institutions
NEER	Nominal Effective Exchange Rate
NRBT	National Reserve Bank of Tonga
NZ	New Zealand
NZD	New Zealand Dollar
OCR	Official Cash Rate
OET	Overseas Exchange Transactions
OPEC	Organization of the Petroleum Exporting Countries
PACER	Pacific Agreement on Closer Economic Relations
PG	Pacific Games
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
SMEs	Small to Medium Enterprises
TASP	Tonga Agriculture Sector Plan
TDB	Tonga Development Bank
TOP	Tongan Pa'anga
UK	United Kingdom
US	United States
USD	United States Dollar
WEO	World Economic Outlook

## Overview

### Recent Development

During the six months to August 2016, the National Reserve Bank of Tonga (NRBT) maintained its accommodative monetary policy stance. The NRBT's objectives to maintain internal and external monetary stability, promote financial stability and a sound and efficient financial system, and to conduct its activities in a manner that supports macroeconomic stability and economic growth by ensuring adequate level of foreign reserves, were achieved although inflation had significantly increased in July due mainly to the enforcement of the new excise tax and customs duty introduced in July 2016.

The domestic economy experienced favourable growth. The NRBT's economic growth estimates for 2014/15 and 2015/16 remained positive and similarly the outlook is for stronger growth over the next two years 2016/17 to 2017/18. The on-going construction activities and strong performance in the trade and tourism sectors are anticipated to drive growth. The Statistics Department has yet to release the official estimates of real GDP for 2014/15 and 2015/16.

The NRBT estimated a stronger real GDP growth of 3.4% in 2015/16 coinciding with the 3.1% growth projected by the IMF Article IV 2016 mission. This is an upward revision from an estimate of 3.3% in the February 2016 MPS, which reflects an expanding primary sector mainly in the fishing and agricultural sectors and a rebound in the forestry sector. In addition, the events that took place during the year such as the King's coronation, annual church conferences, family and village reunions and the celebration of the Tupou College's 150<sup>th</sup> Anniversary boosted activities in the tourism and trade sectors.

The annual headline inflation rose by 5.1% in August 2016 which compares to a period of deflation reported in the NRBT's previous Monetary Policy Statement, and is still below the NRBT's reference range of 6-8%. Over the past six months to August 2016, the overall balance of Overseas Exchange Transactions (OET), which is equivalent to the net change in the foreign reserves, was a surplus of \$37.7 million. This was more than double the surplus recorded for the six months to February 2016 of

\$17.6 million. The improvement in the current account, and the capital account contributed to the higher overall surplus.

Gross official foreign reserves therefore rose to \$366.3 million in August 2016, compared to \$328.5 million in February 2016. This was sufficient to cover 9.2 months of imports, well above the NRBT's minimum range of 3-4 months. In year ended terms, gross official foreign reserves rose by \$55.4 million (17.8%). The lower deficit in the current account balance as a result of higher remittances, higher receipt of foreign aid and budgetary support for the government from donor partners, contributed to the comfortable level of foreign reserves over the past year.

The banking system remained sound over the 6 months to August 2016 as banks continued to be profitable with strong liquidity and capital positions being maintained. Banks' lending grew by \$23.3 million (7.0%) over the 6 months to August due to growth in both household and business loans, supporting economic activities.

The higher foreign reserves during the 6 months to August 2016 contributed to the continued high liquidity in the banking system. Broad money rose over the 6 months to August 2016 by \$34.6 million (7.6%) to another record high of \$491 million. This was driven by a \$47.6 million (14.4%) rise in net foreign assets, offsetting a \$13.1 million (10.3%) fall in net domestic assets. The banking system liquidity (reserve money) increased over the past 6 months to August 2016 by \$9 million (3.5%) to a record high of \$267.2 million. This coincides with higher deposits during the period. Total loans to deposit ratio for the banking system slightly increased to 73.7% in August 2016 from 73.6% in February 2016. This is still below the NRBT's minimum floor of 80% effective from 1<sup>st</sup> July 2016 to be met by December 2016, as the growth in deposits of 6.8% was offset by a 7% growth in bank loans, indicating excess liquidity for the banking system remains.

Banking system data shows the net credit to government fell by \$17.7 million (36.6%) over the 6 months to August 2016 due mainly to higher government deposits during the period.

## Outlook

The 2016/17 real GDP growth estimate has been revised up to 3.6% compared to the February 2016 MPS projection of 1.9%. This upward revision of growth is driven mainly by the outlook for stronger growths in financial intermediation, construction, tourism, trade and agricultural sectors. This estimate is stronger than the 2016 IMF Article IV's real GDP growth estimate of 2.5% - 3.0% over the medium term.

The annual headline inflation rate is expected to be above 6% in the remaining months of 2016 and to fall to around 4% in the beginning of 2017/18. This is attributed to the continued shortage of Kava Tonga, the new customs duty and excise tax which will remain in force, and oil prices are expected to gradually increase from an average of US\$43/barrel in 2016 to US\$51/barrel in 2017 according to the IMF October 2016 WEO.

The level of foreign reserves is projected to remain comfortably above the minimum range of 3 to 4 months of imports until June 2017. Remittances and travel receipts are expected to remain high due to upcoming festivities. Export proceeds are also expected to rise, supported by the positive growth in the agricultural and fisheries sectors, which will partially offset the rising import payments.

Credit growth for 2016/17 was revised upwards from 11% to 15%, which is higher than the projection by the IMF Article IV of 10.8% for 2016/17. The NRBT's

policy measure imposing a minimum requirement on banks' loans/deposit ratios effective 1<sup>st</sup> July 2016

should encourage further lending and support the continued growth in credit and broad money. The NRBT's initiative to encourage lending to Micro, Small and Medium Enterprises is also expected to contribute to credit growth. At the same time, structural reforms in various sectors as well as other impediments to lending such as the improvement to the land administrative system and the bankruptcy laws would improve the confidence of the banks to lend further in a prudent manner.

Net credit to the government is expected to fall, due to anticipated budgetary support and government grants receipts.

Given the recent developments and the outlook on the monetary policy targets, the NRBT considers the current accommodative monetary policy stance to be appropriate in the medium term. The NRBT will remain vigilant and closely monitor early signs of vulnerabilities.



Sione Ngongo Kioa  
Governor

# 1. Global Developments

## World Growth

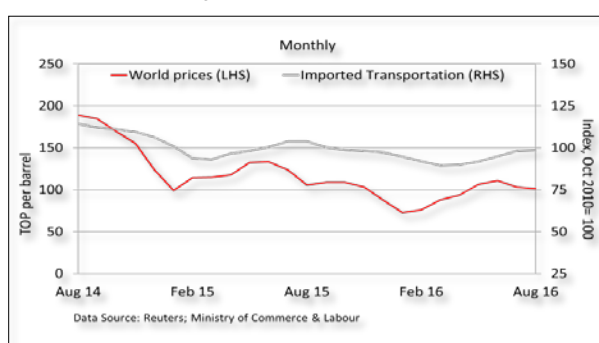
The IMF World Economic Outlook (WEO) in October 2016 has revised downward the global growth outlook for 2016 and 2017 from its April 2016 report, now projected to be 3.1% (from 3.2%) and 3.4% (from 3.5%) respectively. This reflects an expected slowdown in advanced economies due mainly to weaker-than-expected growth in the United States (US) and the United Kingdom (UK) vote in June to leave the European Union (Brexit). The impact of Brexit is still uncertain yet recent developments are expected to exert downward pressure on global interest rates. Further downside risks such as political tensions in the advanced economies, particularly the UK, and European Union (EU) member countries are expected to unfold ahead.

Global headline inflation remained relatively low at 0.5% despite a pick-up in commodity prices, particularly crude oil prices. Employment growth in advanced economies has been stronger than expected. Monetary policy in advanced economies remained accommodative and is expected to tighten more slowly than anticipated in the IMF April 2016 WEO.

## World Oil Prices

Reuters reported that world oil prices averaged around US\$46.94 per barrel in August 2016 increasing from an average of US\$33.52 per barrel in February 2016 but still remained lower than an average of US\$48.14 per barrel a year ago. Oil prices had increased due to the excess oil supply declining, a gradual slowdown in non-OPEC production as well as some supply disruptions.

Figure 1: World Oil Prices



According to the IMF October 2016 WEO, the oil prices in 2016 are expected to increase gradually over the next year from an average of US\$43 per barrel to US\$51 per barrel in 2017. This is due mainly to the outlook for geopolitical tensions in some countries in the Middle East to remain high for the remainder of the year.

## Advanced Economies

Growth in the US was weaker over the first half of the year which triggered a downward revision for economic growth for 2016 from 2.4% to 1.6%, and the 2017 growth forecast has been downgraded from 2.5% to 2.2% by the IMF October 2016 WEO. This was mainly due to weak business and non-residential investment which contributed to a decline in capital spending. A strong US dollar (USD) is expected to be maintained with lower energy sector investment which is anticipated to also contribute to the revised growth projection for the current year. Moreover, inflation rate of 1.2% is projected to rise to 2.3% in 2017. Consequently, in response to persistently weak inflation, markets now expect only one further rate increase in the US during 2016. Sustained improvements were noted in the US labour market reflecting relatively modest growth in employment.

According to the Reserve Bank of Australia (RBA) MPS in August 2016, Australia experienced stronger than expected growth over the March quarter largely due to a substantial rise in resource exports such as liquefied natural gas (LNG) and coal (coking and thermal) exports. Growth over the June quarter was moderate as expected. Over the past six months to August 2016, there was modest growth in household income which led to solid growth in consumption and household investment. The unemployment rate has remained unchanged over the year to August 2016. However, a modest pace of employment growth in the near term is expected. Thus, GDP growth is expected to be around 2.5 - 3.5% for 2016 before increasing to 3 - 4% for 2017 and 2018. The Australian dollar (AUD) has appreciated recently and inflation has been in line with expectations leading to very little change in forecasts. Inflation is expected to remain around 1.5% over 2016 and to possibly pick



up to around 1.5 - 2.5% by the end of 2017. The RBA Board therefore eased the cash rate by 25 basis points in August to support the prospects for sustainable economic growth with inflation at low levels and returning to target over time.

In New Zealand (NZ), the Reserve Bank of New Zealand (RBNZ) cut the Official Cash Rate (OCR) by 25 basis points to 2.0% in August 2016. This was to support economic growth while the headline inflation remained low; with the expectation that inflation will settle near the middle of its target range of 1-3%. The RBNZ announced that monetary policy will need to be more stimulatory than initially projected. The appreciation of the New Zealand Dollar (NZD) due to positive domestic growth prospects and low global interest rates has further reduced the competitiveness of its export and import-competing businesses. In addition, falling prices for NZ's key commodity exports, especially dairy products have reduced farming incomes and spending, affected confidence, consumption, and investment more broadly. However, stronger growth in labour supply from inward migration is limiting wage pressure. The unemployment rate was revised down over the March quarter to 5.2% and continued to remain stable over the June quarter. Labour market conditions have improved over the past year indicating strong labour force growth. Therefore, GDP growth is expected to be 2.5% in 2016 an upward revision from 2.0%, and 3.4% in 2017 which is an upgrade from 2.5% as reported in the February 2016 MPS.

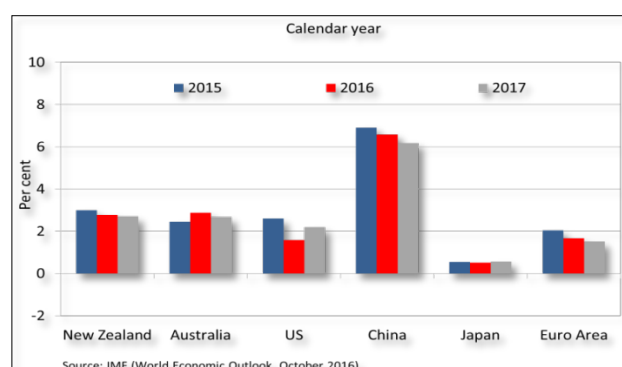
The IMF in its October 2016 WEO reported downward revision for the UK's projected growth as a result of Brexit and the rising uncertainty of significant impacts of Brexit on firms' investment and hiring decisions, consumers' purchases of durable goods, and housing. Despite stronger growth over the first half of the year, domestic economic growth is expected to be 1.8% (down from 1.9%) in 2016 and falling to 1.1% (down from 2.2%) in 2017. The depreciation of the British pound is projected to push inflation up to about 0.7% this year and further expected to rise to about 2.5% in 2017 which is above the Bank of England's inflation target of 2.0%.

In the Euro zone, economic growth was higher than expected in the first half of the year, increasing by 2.1% over the first quarter and 1.2% over the second quarter. This was due to strong domestic demand and some rebound in investment which caused an upward revision in the growth forecast for 2016 to 1.7% in the IMF's October 2016 WEO, from 1.5% in the April 2016 report. However, Brexit is expected to have potential negative impacts on consumer and business confidence with potential bank stresses thus leading to a downward revision of the growth forecast for 2017 from 1.6% to 1.5%. Furthermore, high unemployment is projected for the Euro zone. Inflation has also picked up over the year to 0.3% and is projected to remain low going forward, and below the European Central Bank's target of 2.0% through 2021.

The IMF October 2016 WEO reported that China's short-term outlook has improved due to recent policy measures. This contributed to a slight upward revision of growth forecast for 2016 from 6.5% to 6.6% whilst the growth forecast for 2017 remained unchanged at 6.2%. Policy measures included the cut in benchmark lending rates and expansionary fiscal policy in the second half of 2015 particularly infrastructure spending. Inflation is expected to increase to 2.1% this year and to rise further to 3.0% in 2017.

Activity over the first quarter of the year for Japan was slightly better than expected despite the weak domestic demand and low inflation. The IMF October 2016 WEO also indicated that the appreciation of the yen after the UK referendum is expected to take a toll on external demand and corporate investment.

Figure 2: Growth Projection in the Advanced Economies

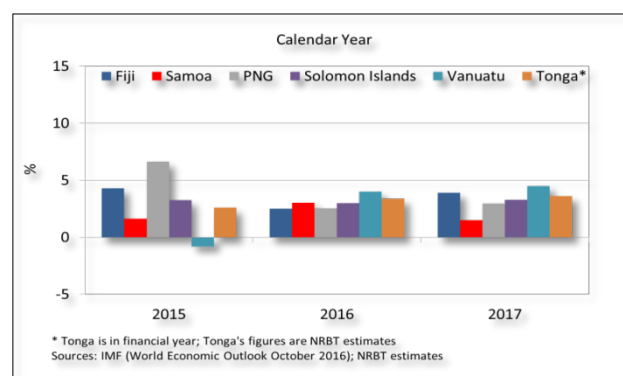


However due to stronger consumer spending the economic growth forecast remained unchanged at 0.5% for 2016. The supplementary budget for 2017 (awaiting to be passed) is expected to provide more fiscal support over the year thus causing an upward revision to the 2017 growth forecast from -0.1% to 0.6%. Inflation is expected to increase slowly and remain below the Bank of Japan's target of 2.0% throughout the forecast horizon.

### South Pacific Economies

According to most respective central banks within the South Pacific region, their economies showed relatively stable growth ranging from 1 – 3% since the February 2016 MPS. Growth is expected to remain moderate whilst inflation is expected to continue to rise reflecting the appreciation of the intervention currency, which is the USD as well as recovering crude oil prices. Amongst the South Pacific economies, the Reserve Bank of Fiji noted that Fiji experienced lower-than-expected tourist inflows and remittances.

Figure 3: Growth Projections in the Pacific



However, this was more than compensated for by the high domestic consumption and investment. This was notably evident in rising demand for construction supplies for rehabilitation work in the aftermath of Tropical Cyclone Winston. The Bank of Papua New Guinea has revised Papua New Guinea's GDP growth downwards reflecting low export commodity prices over the past nine months and a realignment of fiscal spending due to a budget deficit.

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

	Real GDP growth (%)			Inflation (%)			Unemployment* (%)		
	2015	2016 <sup>f</sup>	2017 <sup>f</sup>	2015	2016 <sup>f</sup>	2017 <sup>f</sup>	2015	2016 <sup>f</sup>	2017 <sup>f</sup>
World Growth	3.2	3.1	3.4						
Australia	2.4	2.9	2.7	1.7	1.6	2.0	6.1	5.7	5.7
China	6.9	6.6	6.2	1.6	2.3	2.3	4.1	4.1	4.1
Euro Area	2.0	1.7	1.5	0.2	0.6	1.0	10.9	10.0	9.7
Japan	0.5	0.5	0.6	0.2	-0.1	0.7	3.4	3.2	3.2
New Zealand	3.0	2.8	2.7	0.1	1.4	1.7	5.4	5.3	5.5
United States	2.6	1.6	2.2	0.7	1.8	2.6	5.3	4.9	4.8

Note: f – forecast

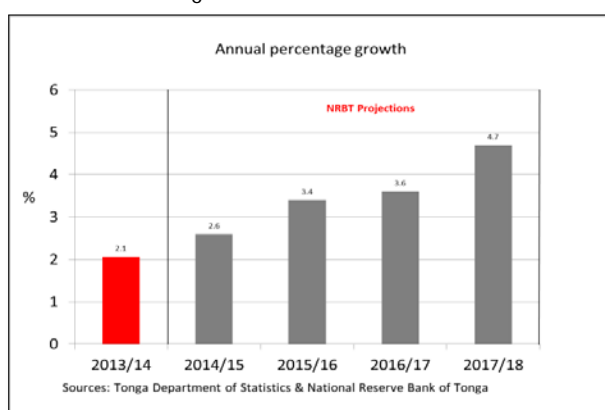
Source: IMF (World Economic Outlook, October 2016), NRBT

## 2. Tonga's Economic Growth

### Real GDP Growth

The domestic economy experienced favorable growth. The NRBT's economic growth estimates for 2014/15 and 2015/16 remained positive and similarly the outlook is for stronger growth over the next two years 2016/17 to 2017/18. The on-going construction activities and strong performance in the trade and tourism sectors are the expected drivers of growth. The Statistics Department has yet to release its official estimates of Real GDP for 2014/15 and 2015/16.

Figure 4: Real GDP Growth



The NRBT estimated a stronger real GDP growth of 3.4% in 2015/16 coinciding with the 3.1% growth projected by the IMF Article IV 2016 mission. This is an upward revision from an estimate of 3.3% in the February 2016 MPS, which reflects an expanding primary sector mainly in the fishing and agricultural sectors and a rebound in the forestry sector. In addition, events that took place during the year such as the King's coronation, annual church conferences, family and villages reunions and the celebration of the Tupou College's 150<sup>th</sup> Anniversary boosted activities in the tourism and trade sectors.

The February 2016 MPS anticipated a real GDP growth of 1.9% in 2016/17, however this has been revised upwards to 3.6%. This upgrade in the growth outlook is driven by anticipated stronger growths in financial intermediation, construction, tourism, trade and agricultural sectors. This is above the 2016 IMF Article IV's projection of growth to be around 2.5% - 3.0% over the medium term.

On the outlook, the NRBT projected a higher growth of 4.7% for 2017/18. This is driven mainly by the construction works for the Pacific Games. Additionally, financial intermediation, transport & communication, trade, fishing and tourism sectors are also expected to contribute to the real GDP growth in 2017/18.

### Primary Production

The NRBT projected growth of 2.1% in the agricultural sector for 2015/16 compared to a 3.0% contraction in 2014/15. This is an upward revision from an estimated growth of 2.0% in the February 2016 MPS. This is supported by a rise in the total volume of agricultural exports by 379.8 tonnes (4.6%) over the year to June 2016. The favourable squash season during the year contributed largely to this rise with total export volume increasing by 1,568.71 tonnes (71.2%) particularly higher exports of squash. The exports of sweet potatoes also rose by 82.0 tonnes (163.3%) over the year to June 2016. Despite the on-going shortage in the supply of kava-Tonga, its export volume increased by 60.7 tonnes (29.6%) reflecting the re-opening of the market in Europe driving the highest export of kava powder recorded in October 2015. Moreover, exports of breadfruit and cassava rose by 24.5 tonnes (36.7%) and 10.2 tonnes (0.7%) respectively. Favourable weather conditions during the year relative to the previous year have contributed to the improvement in the agricultural production.

Figure 5: Volumes of Major Agricultural Exports

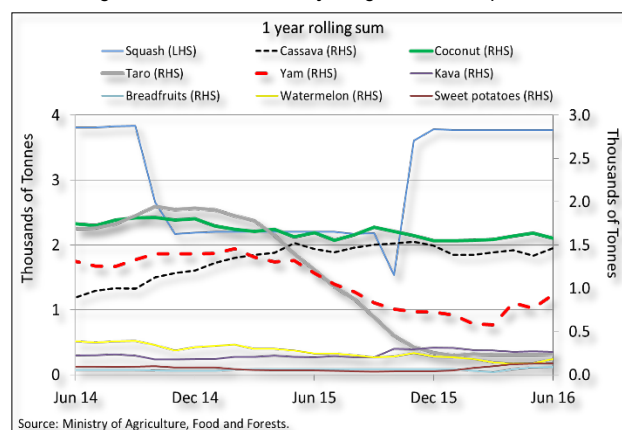


Table 2: Real GDP Growth Forecast

	Official 2013/14	FY 2014/15 (Revised) %	FY 2015/16 (Feb-16 MPS) %	FY 2015/16 (Revised) %	FY 2016/17 (Feb-16 MPS) %	FY 2016/17 (Revised) %	FY 2017/18 (Forecast) %
<b>GDP</b>	2.0	2.6	3.3	3.4	1.9	3.6	4.7
<b>Primary production</b>	3.1	-1.7	2.3	2.5	2.9	2.9	2.5
Agriculture	4.7	-3.0	2.0	2.1	3.0	2.5	2.0
Forestry	4.3	5.5	-2.0	0.1	3.0	0.1	0.2
Fishing	-5.9	5.0	5.0	5.2	2.0	5.3	5.7
<b>Secondary production</b>	1.3	5.3	5.3	4.4	2.6	4.8	9.6
Mining and quarrying	3.2	4.0	3.0	5.0	2.0	5.1	10.0
Manufacturing	0.0	3.0	3.0	3.5	3.0	3.8	6.0
Utilities	-1.2	4.0	3.5	3.5	1.0	3.6	7.0
Construction	3.4	8.0	8.0	5.2	3.0	5.9	13.0
<b>Tertiary production</b>	1.6	3.4	3.5	3.4	1.6	3.4	3.7
Trade	1.1	5.0	5.0	5.3	0.1	5.4	6.5
Hotels, restaurants	-0.4	5.0	4.0	4.6	2.0	4.7	3.0
Transport, communication	0.6	5.0	5.0	5.7	1.0	5.8	5.0
Financial intermediation	4.6	6.2	6.0	6.4	5.0	6.6	7.0
Real estate, business services	1.5	3.0	3.0	3.6	1.5	1.5	2.0
Public administration	0.4	2.0	2.0	1.6	1.0	0.7	1.0
Education	12.0	2.0	2.0	1.0	2.0	2.0	2.0
Health and social work	8.3	1.0	1.0	1.0	1.5	1.5	1.5
Recreational, cultural activities	1.4	1.5	2.0	1.0	2.0	2.0	3.0
Other community services	2.0	2.0	2.0	1.0	2.0	2.0	2.0
Ownership of dwellings	0.4	1.5	2.0	1.0	2.0	2.0	3.0
Other*	4.1	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

Agricultural export proceeds reported by the banking system increased by \$1.4 million (30.2%) to \$6.2 million in 2015/16. The strengthening of the Japanese Yen (JPY), New Zealand Dollar (NZD), United States Dollar (USD) and Australian Dollar (AUD) against the Tongan Pa'anga (TOP) supported the higher export receipts from the export of squash and kava-Tonga.

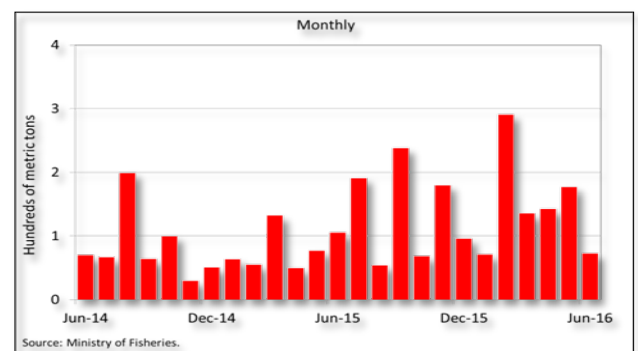
Stronger growth of 2.5% is expected for the agricultural sector in 2016/17, supported by an anticipated rise in domestic production and export volume. Tonga's first Agriculture Sector Plan (TASP) 2016/2020 was launched in July 2016 which supports the growth prospects for the industry. The improvement in the infrastructure for farmers, including the opening of the multi-purpose pack house in 'Eua, should support the expected positive growth in the coming years. The new Farmer Field School in 'Eua may contribute to the growth as more than 20 farmers in 'Eua have graduated from this school. Young farmers were trained on how to grow and sell more food, which is part of the first phase of the Tonga Rural Innovation Project funded by the International Fund for Agricultural Development (IFAD); phase 2 is expected to reach out to more communities in Tonga. The biogas demonstration farm set up with the assistance of the Chinese Government would also provide organic fertilizer that is expected to support the production of high quality fruits such as seedless watermelons. The re-opening of the High Temperature Forced Air (HTFA) facility would support the exportation of papaya, breadfruit, tomatoes and the new products to be introduced such as eggplant and chillies. In addition, the possibility of a new market to China for squash exports may increase total agricultural exports volumes. Tonga is also currently negotiating the Pacific Agreement on Closer Economic Relations (PACER) Plus which may also support growth in the sector.

The Government's Development Loan scheme administered by the Tonga Development Bank (TDB) continued to support the expected growth for the agricultural sector. The August 2016 climate update by the Meteorology Division advised that a weak La Nina (more rainfall than usual during summer) remain possible in 2016. This poses a risk to the growth outlook for the agricultural sector.

A slight upgrade to 5.2% in the growth for the fisheries sector is forecasted for 2015/16 compared to a 5.0% growth projected in the February 2016 MPS. This is supported by a rise in marine exports (excluding aquarium products) over the year to June 2016 by 723.7 metric tons (72.8%). A significant increase in

exports of tuna by 864.9 metric tons (129.8%) over the year to June 2016 drove the higher exports in 2015/16. Exports of snapper also rose by 29.2 metric tons (45.1%). The increase in the number of fishing vessels may have contributed to the overall rise in marine exports. The establishment of a new Ministry of Fisheries separate from the Ministry of Agriculture, Food & Forestry in July 2016 also supports the activities in the fishing sector. The other categories of marine products such as beche der mer, seaweed, shark meat, reef fish and shark fin declined over the year. The exports of fisheries and other marine products brought in \$7.2 million in proceeds over the year to June 2016 as reported by the banking system, rising by \$1.94 million (37.0%) compared to 2014/15. However, the Ministry of Fisheries estimated the value of annual export to be \$10.6 million. This implies export proceeds of \$3.4 million remain unaccounted for over the year.

Figure 6: Fishery Exports



The outlook for the fisheries sector continues to remain positive, supported by the first Tonga Fisheries Sector Plan 2016/2024. The reduction of the import duty rates for some fishing equipment to zero in the Customs Duty Amendment 2016, which was effective on 1<sup>st</sup> July 2016, also supports the anticipated growth in the fisheries sector. The sector continues to benefit from the Government's Development Loans scheme, which is facilitated by the TDB, with an additional 11 loans to the fishing sector of TOP\$0.5 million since the last MPS. The introduction of the Air New Zealand Boeing 777-200 aircraft provides extra capacity for more exports volume. The trial seaweed farm and the expansion of the pearl industry are still on-going and is expected to contribute to the 5.3% growth forecast for the fisheries sector in 2016/17. Furthermore, various fishermen have indicated through the NRBT's liaison program their plans to explore new market opportunities, increase the number of vessels and also improve the existing infrastructures such as expand the storage area, packing facility and ice making machine. The

completion of the upgrade of the Fuaa wharf in 2018 will allow greater access for local ferries to offload cargo.

A rebound of 0.1% growth is forecasted for the forestry sector in 2015/16, and similarly for 2016/17. This is an upward revision from a negative growth of 2.0% for 2015/16 projected in the February 2016 MPS but a downgrade from the forecast for 2016/17 of 3% in the previous MPS. According to liaisons with Tonga Power Limited, there were major network upgrade projects in Tongatapu and Ha'apai in 2015/16 therefore an increase in demand for poles supplied by Tonga Forest Product Limited, which supported this upward revised forecast. However, the exports of sandalwood continued to decline by 8.7 tonnes (94.0%) over the year to June 2016.

### Secondary Production

The on-going construction activities in the country contributed to a strong performance in the construction and mining & quarrying sectors in 2015/16. The completion of major construction projects during 2014/15 supports the downward revision to the projected growth of 4.4% for the secondary sector in 2015/16, from 5.4% projected in the February 2016 MPS. The construction works completed during 2015/16 included the reconstruction and refurbishment of primary schools and the Maamaloa Kindergarten, as well as the new Red Cross Centre, barracks for women police recruits, and a gas station in Kolofo'ou.

The projected growth for the construction and manufacturing sectors in 2016/17 have both been revised up to 5.9% and 3.8% respectively from 3% in the February 2016 MPS. This is supported by the rise in private individuals' housing loans and business loans for construction and manufacturing. The on-going construction projects such as the St. George Palace, renovation of the Tanoa International Dateline Hotel, LDS chapels, major upgrade and extension of Nuku'alofa's domestic wharf, preparation for the Pacific Games and various other construction projects are expected to drive growth in 2016/17 and later years. Private construction works are also expected to rise in the next few years.

A number of both public and private construction projects are already in the pipeline, such as a new office building for the Utilities sector, LDS buildings, hospital for Ha'apai, preparations for the Pacific Games in 2019 and other projects will also help to boost activities in the sector. There is also potential

for further boost in growth in the handicrafts sector in line with the expected growth in the tourism sector.

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. Electricity consumption increased by 4.18 million kW over the year to June 2016 coinciding with a 4.30 million kW rise in electricity production and 689 rise in the number of electricity consumers. This is supported by a \$0.10 seniti fall in electricity prices which was mainly due to a decline in world oil prices to US\$50.06 per barrel in June 2016 from US\$62.01 per barrel in June 2015. The continued fall in global oil prices benefitted the transportation sector as it contributed to higher purchasing power for consumers.

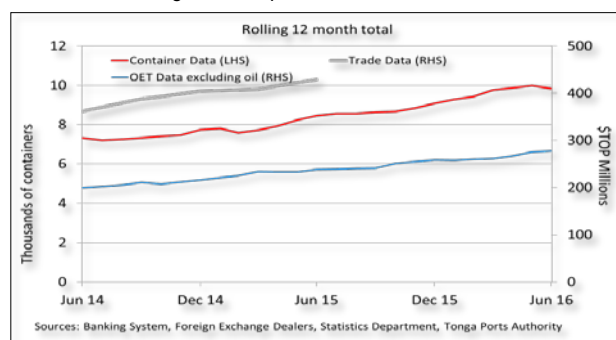
### Tertiary Production

Despite the downward revision of estimated growth for the tertiary sector in 2015/16 to 3.4% from 3.5% projected in the February 2016 MPS, the trade, tourism, transport & communication, and financial intermediation sectors are expected to record stronger growth over 2015/16 compared to the previous year.

In year ended terms, the number of registered containers rose by 1,389 registrations (16.4%) in June 2016. Both private and business containers rose with private containers increasing the most by 743 registrations (21.2%). This reflected events that took place during the year, including the King's coronation, annual church conferences, reunions and the Tupou College's 150<sup>th</sup> anniversary. The increasing number of imported second hand cars ordered online from Japan resulted in a rise in the number of registered vehicles by 770 registrations (34.0%). Furthermore, there is increased demand for new vehicles by the returning Recognized Seasonal Employees (RSE) workers from overseas. Moreover, the trade sector benefitted from the \$36.1 million (22.8%) rise in banks' lending to households over the year. Looking ahead, scheduled events for 2016/17 such as the 100<sup>th</sup> anniversary of the LDS mission, school anniversaries particularly for Chanel College Kelana, Tailulu College (Tongatapu) and Mailefihi Siu'ilikutapu College and annual church conferences will lift growth in the trade sector. These events will also contribute to growth in the other sectors. The upgrade and extension of the Fuaa wharf which is expected to be completed by 2018, will contribute significantly to improving the safety of domestic inter-island transportation, and further support economic activity.



Figure 7: Import Indicators

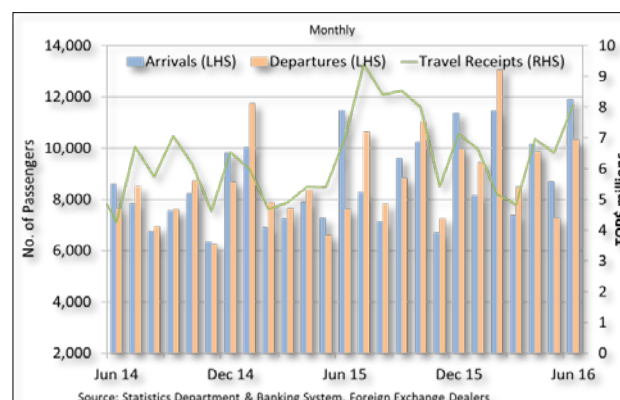


Tourism activity was vibrant in 2015/16 supported by the events that took place during the year. International arrivals continued to rise by 13,785 passengers (14.2%), driven mainly by an increase in air arrivals of 9,736 passengers (11.9%). Additionally, cruise ship arrivals rose by 4,022 visitors (28.4%), which reflected a higher number of cruise ships arriving during 2015/16 compared to the previous year. The introduction of the Air New Zealand Boeing 777 flights and the commencement of the Fiji Airways' direct flights from Fiji to Vava'u in April 2016 also supported the higher arrivals. The increase in international arrivals were mainly visitors from NZ, US and Australia. This is consistent with a \$14.9 million (21.3%) rise in travel receipts over the year to June 2016. This was also supported by the strengthening of the NZ, US and Australian dollar against the Tongan pa'anga.

On the outlook for this sector, the signing of the mutual visa exemption agreement between Tonga and China and the setting up of Chinese group tours are expected to attract more tourists from China. The completion of the renovation of the International Dateline Hotel by the Tanoa Group is also anticipated to attract more tourists and to boost the tourism industry in the years to come. The scheduled events for 2016/17 may also contribute to growth, which includes the LDS 100<sup>th</sup> anniversary, school anniversaries particularly for Chanel College Kelana, Tailulu College (Tongatapu) and Mailefihi Siu'ilikutapu College, and annual church conferences.

Activities in the financial intermediation sector remained strong supported by continued high credit growth in 2015/16. The increasing activity in this sector was supported by more funds available from the Government's Development Loan scheme which is facilitated by TDB. The low interest rates and the ongoing competition among banks further contributed to growth. There is excess liquidity in the banking system which NRBT anticipates will support strong lending growth in the future.

Figure 8: International Air Arrivals &amp; Travel Receipts



## Unemployment

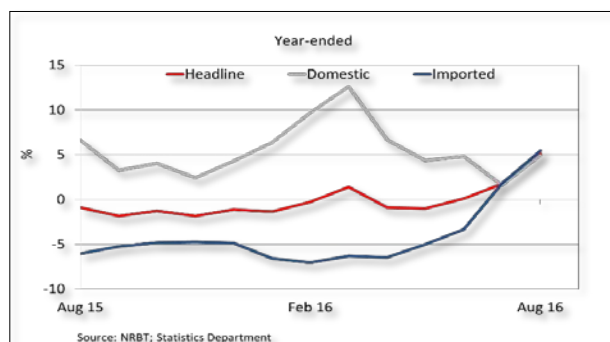
The unemployment rate remained at 6.5% as reported in the last MPS. According to the NRBT's survey of job advertisements, recruitment intentions over the past six months were noted mainly in the hotel & restaurant, public administration and business services sectors. New recruitments for the opening of the Tanoa International Dateline Hotel scheduled for November 2016 as well recruitments by Government at the beginning of its new fiscal year in July 2016 contributed to this growth. Recruitment intentions were stable in the year to August 2016. The NRBT expects the economy to grow firmly in the medium term with increased demand for labour supporting a lower unemployment rate.

### 3. Promoting Low and Stable Inflation

#### Recent Developments

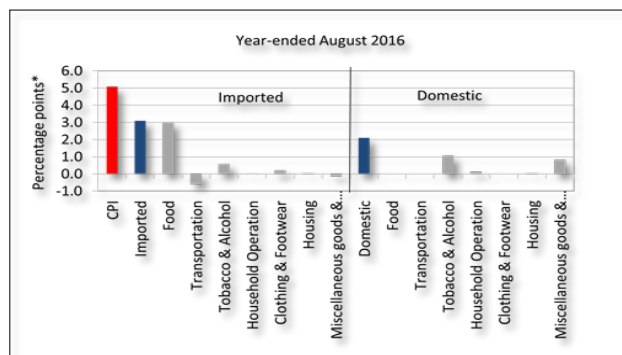
The annual headline inflation rose by 5.1% in August 2016 compared to a period of deflation reported in the NRBT's February 2016 Monetary Policy Statement.

Figure 9: Inflation



The introduction of new customs duty and excise tax on certain cuts of meat and tobacco in July 2016 has contributed to a significant rise in annual headline inflation in July and August 2016.

Figure 10: Contributions to Inflation

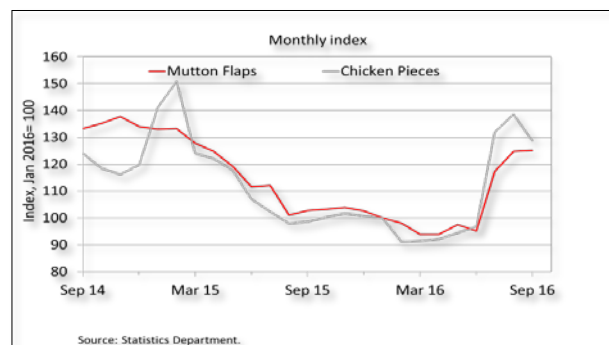


The annual imported inflation rose by 5.3% in August 2016. This was noticeable in the prices of food, beginning in May to date. The government also introduced in June a levy on financial transactions with countries abroad to generate revenue for funding of the 2019 Pacific Games. This was passed on by some banks and authorized restricted foreign exchange dealers to their customers through levy fees, while a few banks had chosen to absorb the levy. Driving prices up was a shortage in the supply of sugar and flour, followed by the excise tax on tobacco and certain meat products that became effective on 1<sup>st</sup> July 2016.

Another driver of imported inflation over the year has been the recent pick up in prices of imported fuel since April; particularly the private transportation component of the CPI which comprises of petrol and diesel.

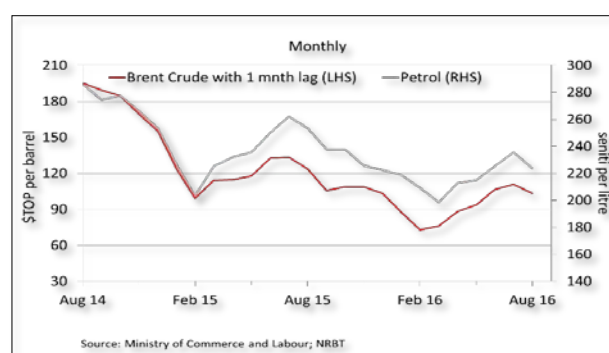
World oil prices have been on the rise since the end of the first quarter. This flows through to local prices with a lag of 1-2 months.

Figure 11: Meat Prices



The US dollar strengthened against the Pa'anga over the past six months to August 2016, which contributed to some of the rise in imported transportation prices.

Figure 12: World Oil Price vs Petrol Price



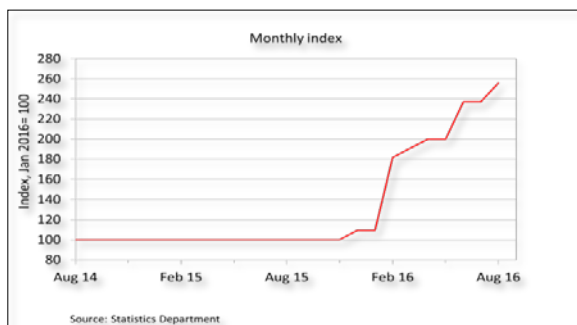
The prices of domestic items in the Consumer Price Index increased by 4.9% over the past year. The food component carries the most weight in the items of domestically produced goods. The past six months has seen the rise in the prices of the domestic food component slow. This is largely due to favorable weather conditions this year resulting in an increase in the supply of food.

On the other hand, this was offset by the rise in the price of kava since the beginning of the year. Dry weather conditions for the past two years have resulted in a shortage of kava powder production. Actual Kava prices have risen from \$25 per kilogram since the start of the year to \$100 per kilogram. In addition, a shortage of miscellaneous goods such as locally made bricks, due to high demand from



construction works, had also contributed to a rise in the price of these goods.

Figure 13: Price of Kava Tonga



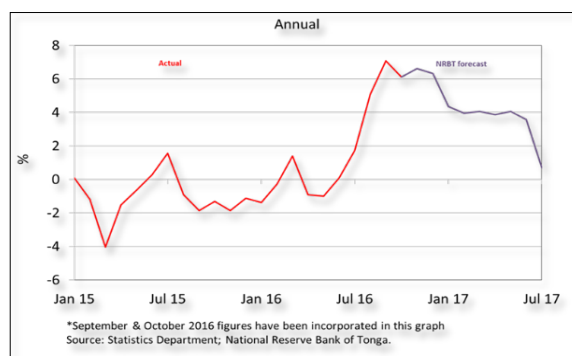
## Outlook

Given the continued shortage of Kava Tonga and new customs duty and excise tax on imported food (which makes up more than a quarter of the CPI basket) will remain in force, the expectation for the oil prices to increase gradually from an average of US\$43 per barrel in 2016 to US\$51 per barrel in 2017 according to the IMF October 2016 WEO, the NRBT expects upward inflationary pressure remains in the near term.

The NRBT forecasts the annual headline inflation rate to be above 6% in the remaining months of 2016 and to fall to around 4% in the beginning of 2017/18.

Further developments in global food and oil prices pose a risk to this outlook. Tonga's vulnerability to natural disasters poses a risk to production in the agricultural, fisheries and other sectors which can also greatly impact prices posing a risk to the inflation outlook.

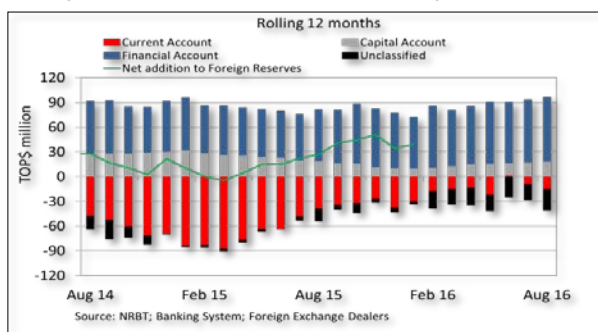
Figure 14: Headline Inflation Forecast



## 4. Maintaining Adequate Level of Foreign Reserves

The NRBT 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 imports cover. The estimates of the balance of payments are based on the OET data collected by the NRBT from banks and Foreign Exchange Dealers (FEDs).

Figure 15: Balance of Overseas Exchange Transactions



### Balance of Overseas Exchange Transactions

Over the six months to August 2016, the overall balance of OET, which is equivalent to the net change in the foreign reserves, rose to a surplus of \$37.7 million. This was more than double the surplus recorded for the past six months to February 2016 of \$17.6 million. The surplus in the capital and current account following a deficit in the previous six-month period, and the rising surplus in the capital account contributed to the higher overall surplus.

Over the year to August 2016, the overall balance also recorded a surplus of \$55.4 million which is \$28.4 million (105.9%) higher than the surplus over the year to August 2015. The narrowing of the deficit balance in the current account and the rising surplus in the financial account over the year drove the higher annual overall surplus.

### Current Account

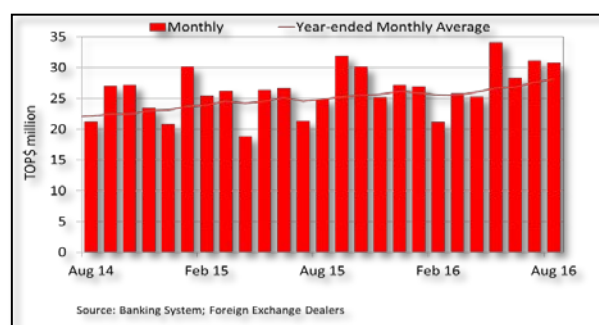
The current account recorded a surplus of \$2.6 million over the last six months to August 2016, in contrast to a deficit of \$19.2 million over the past six months to February 2016. The current account surplus largely benefitted from higher inflows of government grants and budget support, and remittances. However, the deficit in the trade balance widened to \$168.3 million as export receipts fell by \$2.6 million (26.8%) while import payments increased over the past six months by \$1.3 million (8.0%).

Over the year to August 2016, the current account

balance recorded a deficit of \$16.6 million narrowing significantly from a deficit of \$41.0 million reported for the year ended August 2015. The higher inflows of both official and private transfers more than offset the impact of higher import payments. Services and Income both reported higher surpluses over the year which also contributed to the lower deficit in the current account.

Majority of the current account payments over the past six months to August 2016, were for import payments totaling to \$175.4 million, 8.0% higher than it was in the six months to February 2016. The rising import payments over the past 6 months were due mainly to higher payments for import of construction materials and motor vehicles, whilst minimal changes were noted in the payments for import of oil, wholesale and retail trade, and other imported goods mostly by the Government. The construction industry has been very active with various ongoing large construction projects such as the St George Palace, Tanoa International Dateline Hotel and the new Tupou College buildings to name a few. The rising number of housing loans also supported the higher demand for construction materials. On the other hand, easier access to online trading facilities, increased competition with the local car dealers and higher demand for cars from the rising number of RSE workers contributed to the higher import of second hand motor vehicles.

Figure 16: Import Payments

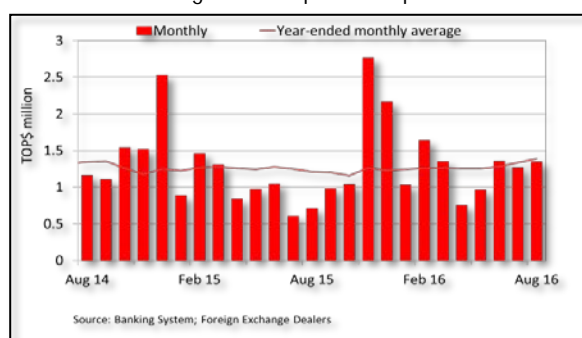


On a yearly basis, import payments rose by 13.2% to \$337.8 million in August 2016 again driven by increasing import payments for construction materials and motor vehicles, which were partially offset by the declines in import payments for oil, wholesale & retail trade and other imported goods. Container registrations reported a 17.9% rise over the year and similarly the construction permits increased over the year, which supported the higher construction import payments. In the six months to August 2016, total export receipts fell by 26.8% to \$7.1 million which was

in line with the slowdown in agricultural exports following the squash harvesting season in the previous six months to February 2016. With reference to the same six months period last year, proceeds from fish and other marine exports has improved significantly indicating growth in the fishing sector.

Total export proceeds for the 12-month period ended August 2016, rose by \$2.1 million (14.8%) to \$16.7 million, reflecting increases in the proceeds of agricultural exports by \$1.6 million (34.6%), and marine exports by \$2.5 million (47.1%). This is consistent with the stronger growth in the agricultural and fisheries sectors.

Figure 17: Export Receipts

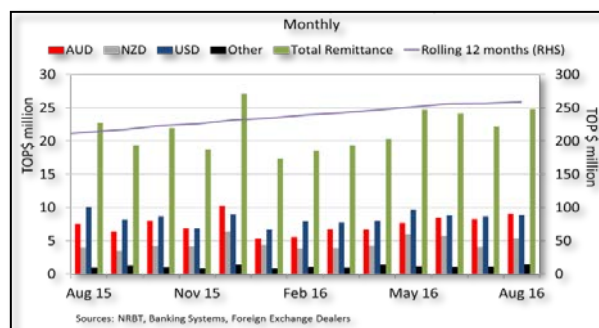


Transfer receipts played a major role in the performance of the current account in the six months to August 2016. Remittance receipts drove the rise in private transfers as it increased by 11% to \$135.6 million. This included \$5.5 million receipts from residents working in the Regional Seasonal Employee's (RSE) scheme overseas, compared to \$3.0 million in the 6 months prior. Official transfers also rose significantly by \$51.4 million (78.0%) in the past six months due to large inflows of budgetary support and government grants in the months nearing the end of the 2015/16 fiscal year. The strengthening of the NZD and the AUD against the TOP over the six-month period ended August 2016 also benefitted Tonga as a recipient of foreign currency.

Total transfer receipts in year ended terms rose to \$345.7 million, 23.7% higher than the previous year. Although de-risking has resulted in closing of some of the authorized restricted foreign exchange dealers' bank accounts and/or their overseas agents' bank accounts, the inflow of remittances continued to grow reaching \$257.2 million in the year ended August 2016. This was 21.9% higher than the previous year and represented 38.3% of the total OET receipts. Various celebrations throughout the year such as the Tupou College's 150<sup>th</sup> Anniversary, Queen Mother's birthday, LDS Centennial Celebration together with the

churches' annual conferences contributed to the higher inflow of remittances. Total receipts from RSE workers increased to \$8.5 million for the 12-month period ended August 2016 compared to \$6.4 million in the previous year. It is estimated that remittances as a share of GDP for 2015/16 was 34.5%. Official transfers also rose to \$80.3 million over the year due to receipts of government budget support, grants and donor funds for government projects.

Figure 18: Remittances by currency



Net services receipts have slowed over the 6 months to August 2016 to \$6.7 million compared to \$11.8 million in the six months to February 2016. Despite the rising receipts from travel and telecommunication services, relatively higher payments made for professional, management and business services weighed on the overall contribution of services to the current account. For the 12-month period ended August 2016, services recorded a surplus of \$18.4 million compared to \$11.7 million in August 2015, underpinned by higher travel receipts.

### Capital Account

Capital receipts rose by \$3.4 million to \$12.1 million over the six months to August 2016 which was attributed to receipts for private capital investments. This included receipts by TOA Corporation, the construction company for the new domestic wharf, and Maori Trust who recently bought Tonga Forest Product Ltd. On the other hand, capital payments declined over the same period to \$0.2 million. Therefore, the capital account balance recorded a surplus of \$11.9 million over the six months to August 2016.

In year ended terms, the capital account recorded a surplus of \$18.5 million, which was 2.6% lower than the surplus for the year ended August 2015 due to lower receipt of funds for capital investment projects compared to the previous year.

### Financial Account

Financial account receipts rose by 2.6% to \$60.1 million over the six months to August 2016 due to inflows of foreign direct investments. Financial

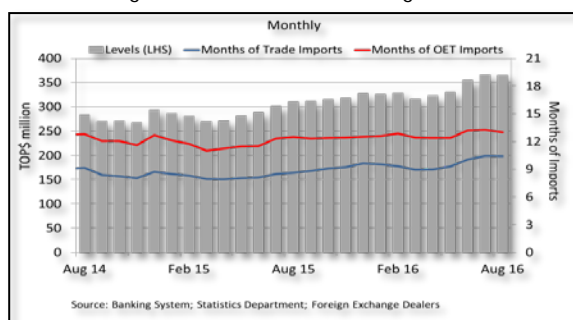
payments also rose by 4.5% to \$20.9 million which were mostly in the form of interbank transfers. Financial account then recorded a surplus of \$39.2 million over the six-month period ended August 2016 compared to a surplus of \$38.6 million in the past 6 months to February 2016.

In the year ended August 2016, the financial account balance recorded a surplus of \$77.8 million, which is 25.2% higher than the surplus in the year ended August 2015, reflecting growth in foreign direct investment and interbank transfers.

The balance of unclassified transactions was an average outflow of \$2.0 million per month over the 12 months to August 2016, compared to \$1.1 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

Figure 19: Gross Official Foreign Reserves



Gross official foreign reserves continued to rise reaching \$366.3 million in August 2016, compared to \$328.5 million in February 2016. This was sufficient to cover imports of merchandise goods for 9.2 months, well above the NRBT's minimum range of 3-4 months of imports. In year ended terms, gross official foreign reserves rose by \$55.4 million. The lower deficit in the current account balance as a result of higher remittances, higher receipt of foreign aid from donor partners and budgetary support for the government, contributed to the higher foreign reserves over the past year.

### Exchange Rates

The Nominal Effective Exchange Rate (NEER) fell by 2.3% over the six months to August 2016 as the AUD, NZD, FJD, and JPY strengthened against the TOP. The Real Effective Exchange Rate (REER) however, rose over the same period by 1.5% reflecting the impact of Tonga's higher inflation relative to that of its major trading partners. Over the year, both the NEER and the REER fell by 6.5% and 3.0% respectively

benefitting Tongan exporters and recipients of foreign currency.

### Outlook

The NRBT expects the level of foreign reserves to remain comfortably above the minimum range of 3-4 months of import up to June 2017 based on the following key factors:

- The deficit balance in the current account is expected to continue to narrow despite higher imports being fuelled by firmer lending outcomes.
- Expected growth from agricultural and fisheries activities can boost export proceeds which will partially offset the rising import payments.
- Remittances are expected to remain at high levels over the coming months due to upcoming holiday season and scheduled events for 2017 such as school anniversaries and annual church conferences. Rising number of people joining the RSE schemes also contributes to higher remittances.
- 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 will positively impact 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 and the preparations for the upcoming Pacific Games.

Risks to the outlook of the foreign reserves may be subject to the following:

- Delays to the inflow of aid and budget support from development partners combined with the pace of development in domestic economic activities poses a risk to the foreign reserves outlook.
- The significant rise in external debt service to Export- Import (EXIM) Bank of China in financial year 2018/19 and preparations for the 2019 Pacific Games is also expected to put pressure on the level of foreign reserves.
- Tonga is highly vulnerable to natural disasters which can greatly impact export and travel receipts.
- Significant increase in the world fuel and commodity prices can harm Tonga's external position as a price taker.



## 5. Promoting a Stable Financial System

The banking system remained sound over the 6 months to August 2016 as banks continued to be profitable with strong liquidity and capital positions being maintained. Over the 6 months to August 2016, both total lending and deposits recorded another record high and the low

continued rise in the foreign reserves. In addition, currency in circulation increased by \$1.7 million (3.7%) over the year reflecting the increase in demand for the new design notes and coins.

The banking system liquidity<sup>1</sup> (reserve money)

Table 3: Consolidated Balance Sheet of Depository Corporations

	Aug 15 \$TOPm	Level Feb 16 \$TOPm	Aug 16 \$TOPm	YoY change Aug 16 \$TOPm	%
<b>Broad money liabilities</b>	<b>424.2</b>	<b>456.5</b>	<b>491.0</b>	<b>66.9</b>	<b>15.8</b>
Currency in circulation	46.7	47.6	48.4	1.7	3.7
Demand deposits	158.6	182.3	194.8	36.2	22.8
Savings and Term deposits*	218.8	226.6	247.8	29.0	13.2
<i>Equals</i>					
<b>Net foreign assets</b>	<b>302.4</b>	<b>330.3</b>	<b>377.9</b>	<b>75.5</b>	<b>25.0</b>
<i>Plus</i>					
<b>Net domestic assets</b>	<b>122.4</b>	<b>126.2</b>	<b>113.4</b>	<b>-9.0</b>	<b>-7.3</b>
Gross bank lending**	318.5	340.5	364.1	45.7	14.3
Other***	-196.1	-214.0	-250.7	-54.6	27.9

\* 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

weighted average interest rate spread was maintained. Consistent with the high foreign reserves level and banking system liquidity, broad money rose to its highest level.

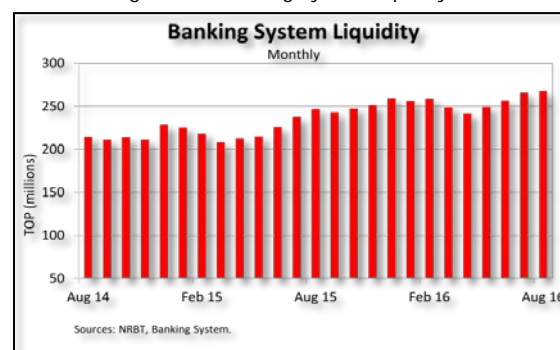
### Money Supply

Broad money rose over the past 6 months to August 2016 by \$34.6 million (7.6%) to a record high of \$491 million compared to \$456.5 million in February 2016. This was driven by a \$47.6 million (14.4%) rise in net foreign assets, offsetting a \$13.1 million (10.3%) fall in net domestic assets. Higher foreign reserves continued to drive the increasing net foreign assets while an increase in government deposits contributed to the decline in net domestic assets.

Over the year, broad money increased by \$66.9 million (15.8%) largely led by a significant increase in net foreign assets of \$75.5 million (25.0%), which outweighed a \$9.0 million (7.3%) decline in net domestic assets. This is the highest annual growth recorded for net foreign assets which is attributed to the

increased over the past 6 months to August 2016 by \$9.0 million (3.5%) to a record high of \$267.2 million, compared to a \$12.0 million (4.9%) rise in the 6 months to February 2016. This coincides with higher deposits in the past 6 months. Total loan to deposit ratios slightly increased to 73.7% in August 2016 from 73.6% in February 2016 as the growth in deposits of 6.8% was offset by a 7% growth in bank loans. This is still below the 80% minimum ratio that is

Figure 20: Banking system liquidity



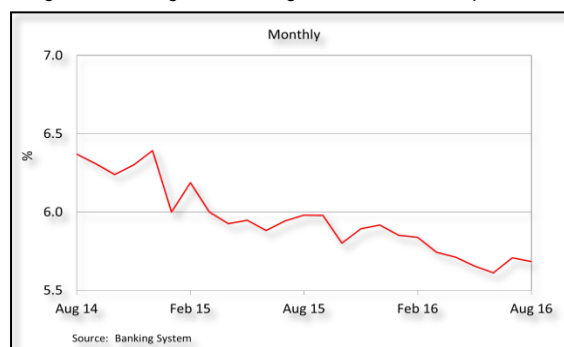
<sup>1</sup> Liquidity (reserve money) in the banking system is a sum of currency in circulation, exchange settlement account balances, and required reserve deposits.

targeted to be achieved by December 2016 indicating excess liquidity in the banking system remains. In year ended terms, liquidity in the banking system rose by \$20.9 million (8.5%), reflecting an increase in banks' deposits.

## Interest Rates

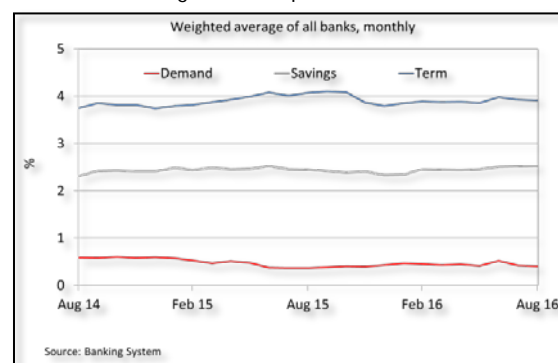
The weighted average lending rate decreased by 12.6 basis points (8.03% to 7.90%) over the past 6 months whilst the weighted average deposit rate rose by 2.9 basis points (2.19% to 2.22%). This resulted in the banks' weighted average interest rate spread narrowing by 15.5 basis points to 5.68% in August 2016 from 5.84% in February 2016. The continued high liquidity in the banking system and the active competition amongst banks largely supported the lower weighted average lending rate whilst the increasing level of deposits contributed to the increase in the weighted average deposit rate. Annually, the weighted average interest rate spread narrowed by 29.6 basis points as a result of a decline in the weighted average lending rate of 35.9 basis points, outweighing a decrease in weighted average deposits rate of 6.3 basis points. The decline in the weighted

Figure 21: Weighted Average Interest Rates Spread



average lending rate over the year was due mainly to a decline in the business lending rate of 44.5 basis points. The increased activities in the agricultural, tourism, fisheries, trade and manufacturing sectors were supported by lower business lending rates.

Figure 22: Deposit Rates



The low interest rates on Government Development Loan scheme contributed to the lower weighted average lending rates, which also supported the agricultural, tourism, manufacturing and also fisheries sectors.

On the other hand, the weighted average deposit rate increased to 2.22% in August 2016 from 2.19% in February, due to a rise in the saving and term deposit rates offsetting a fall in the demand deposit rate. The highest increase was in the weighted average saving deposit rate which rose by 6.4 basis points and the weighted average term deposit rate increased by 2.8 basis points. This, coupled with the higher foreign reserves level, supported a rise in total deposits over the 6 months to August 2016 to a new record high of \$481.9 million. In year ended terms, the weighted average deposit rate fell by 6.3 basis points. The weighted average saving and demand deposit

Table 4: Lending Rates  
Weighted average of all banks

	Level as at			Change over 6 months to		Loan share	
	Aug 16 %p.a.	Feb 16 %p.a.	Aug 15 %p.a.	Aug 16 Bps	Aug-15 bps	Aug 16 %	Feb-16 %
All	7.90	8.03	8.26	-12.6	-35.9	100	100
Housing	8.08	8.18	8.52	-10.2	-44.3	41	38
Other personal	11.00	11.03	11.41	-3.1	-41.1	16	18
Business*	6.94	7.17	7.38	-23.1	-44.5	27	26
Other	6.54	6.25	6.25	28.6	28.6	16	19

\*Included Statutory Non-financial Corporation and Other Financial Corporations

rates rose but were insufficient to offset the decline in the weighted average time deposit rate.

### Lending

Total bank lending reached \$355.2 million in August 2016, an increase of \$23.3 million (7.0%) from February 2016. This is slightly higher than the \$21.9 million (7.1%) growth in the 6 months to February 2016. This was due mainly to growth in household loans of \$19 million (10.8%) followed by growth in business loans of \$4.3 million (2.7%). This indicates growing economic activities particularly tourism, agriculture, construction, manufacturing and wholesale & retail trade. Additionally, the new civil servants remuneration structure that became effective in July 2016 may have increased the borrowing capacity of some households and thereby contributed to the rise in lending to households. Lending growth over the past 6 months has also been supported by the fall in the weighted average lending rates. The new loan commitments slightly fell over the 6 months to August 2016 by \$0.1 million (1.0%) to \$12.8 million, compared to a \$2.4 million (23.3%) rise over the 6 months to February 2016. The decline in new loan commitments to businesses outweighed a rise in new loan commitments to households.

The continuous increase in all household loan categories over the 6 months to August 2016 drove a \$19.0 million (10.8%) rise in banks' lending to households to a new high of \$194.3 million, compared to a \$17.1 million (10.8%) rise in the 6 months to February 2016. Housing loans increased the most by \$18.6 million (15.7%). This is in line with a \$1.3 million (13.9%) increase in new household loan commitments to \$11.1 million. The decline in the weighted average lending rate on individual housing loans by 10.2 basis points supported the higher credit growth.

The NRBT in its liaison program with the Ministry of Infrastructure and Tourism had found that people are experiencing easier access to housing loans at both the banks and non-bank financial institutions such as the

Retirement Fund Board (RFB) who had recently introduced a new home improvement loan facility.

In addition, vehicle loans rose over the 6 months to August 2016 by \$0.2 million (60.8%), which is consistent with a rise in vehicle registrations by 165 vehicles (11.0%) in the past 6 months. Other personal loans increased by \$0.2 million (0.3%), which reflected the strong consumer demand due to annual events and celebrations that took place in the past 6 months.

An increase in loans to the tourism, agricultural, construction, manufacturing, trade and fisheries sectors over the 6 months to August 2016 contributed to a \$4.3 million (2.7%) rise in banks' lending to businesses to \$159.6 million. This is slightly lower than the \$4.9 million (3.2%) growth in the 6 months to February 2016. This was supported by a 23.1 basis points decline in the weighted average lending rate for business loans. Lower interest rates in the Government Development Loan scheme specifically on agricultural, tourism, manufacturing and trade sectors also partially supported the increase in business lending.

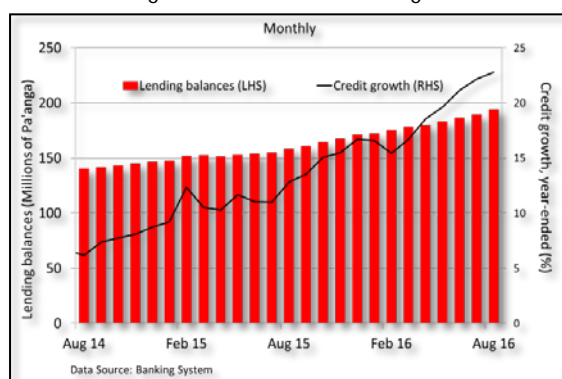
New business loan commitments however decreased over the 6 months to August 2016 by \$0.3 million (15.3%) to \$1.7 million driven by lower commitments to most of the sectors except for the tourism and agricultural sectors. Only 2.1% of the total loans were funded from the Government's development loan scheme as at the end of August 2016, increasing from 1.4% in February 2016.

Over the year, total bank lending rose by \$45.2 million (14.6%) which was largely a result of an increase in household loans of \$36.1 million (22.8%) followed by a rise in business loans of \$9.1 million (6.1%). This coincides with an increase in new loan commitments of \$2.3 million (22.0%), which were mainly household loan commitments.

The higher lending to households over the year ended August 2016 was due to rises in all household lending categories with housing loans increasing the most by \$32.6 million (31.2%). This is in line with higher import

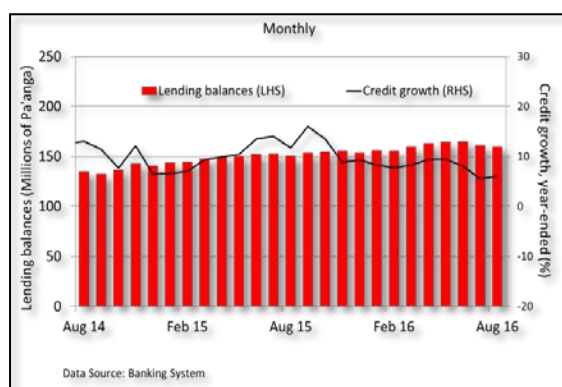
payments for construction materials and vehicles over the year. New household loan commitments also rose by \$3.6 million (48.4%) led by an increase in housing loan commitments.

Figure 23: Household Lending



In year ended terms, the growth in banks' loans to businesses was underpinned mainly by rises in lending to the tourism, construction, manufacturing and agricultural sectors. The lower weighted average lending rates to businesses over the year supported the annual growth in business loans.

Figure 24: Business Lending

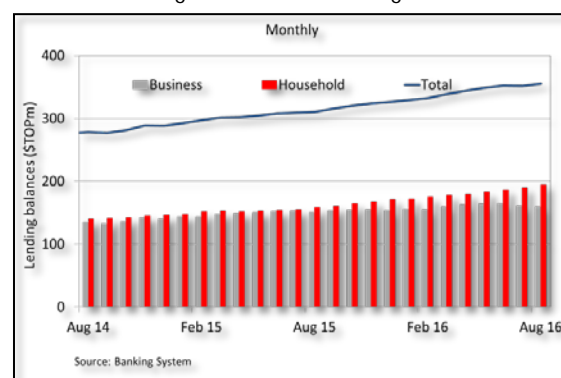


Lending activities in the non-bank financial institutions<sup>2</sup> also increased over the year by \$12.5 million (11.0%), due to a rise in household loans of \$13.2 million (22.2%) offsetting a decline in business loans. The total funds allocated for the Government's development loan scheme was about \$13 million which was effective in August 2014 for a

<sup>2</sup> This includes SPBD, RFB & Government on-lent loans

term of 6 years, which has not been completely utilized as at the end of August 2016.

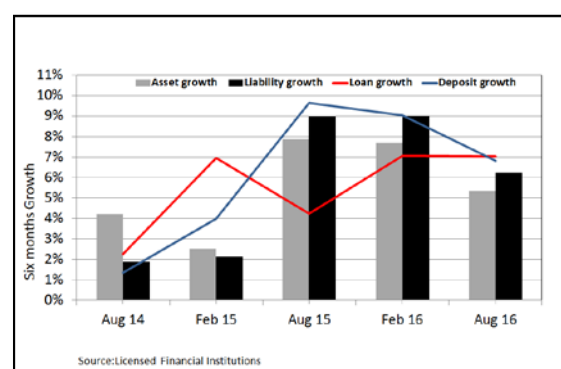
Figure 25: Bank's lending



## Banking System Performance

The banking system remained sound during the six months to August 2016. The total assets of the banking system increased by \$35.6 million (5.3%) to \$703.4 million over the six months to August 2016 mainly due to growth in total loans, nostro accounts, and the exchange settlement accounts. This coincides with the high liquidity in the banking system.

Figure 26: Total Banking System Balance Sheet Development



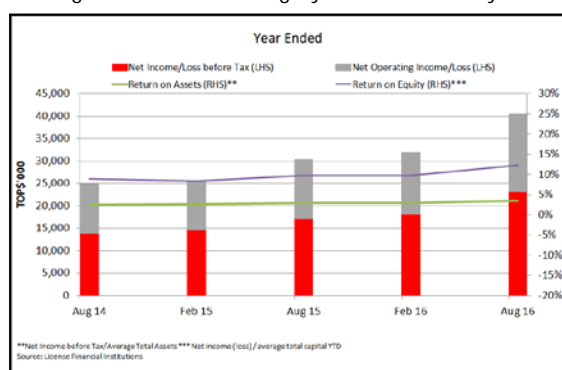
Similarly, total liabilities increased by \$32.6 million (6.2%) to \$557 million, due mainly to a \$30.7 million (6.8%) growth in total deposits over the past six months to August 2016.

The banking sector continued to remain profitable. For the year ended August 2016, the Net Profit After Tax was \$17.2 million, an increase from \$13.6 million in February 2016, and \$13 million in August last year. This



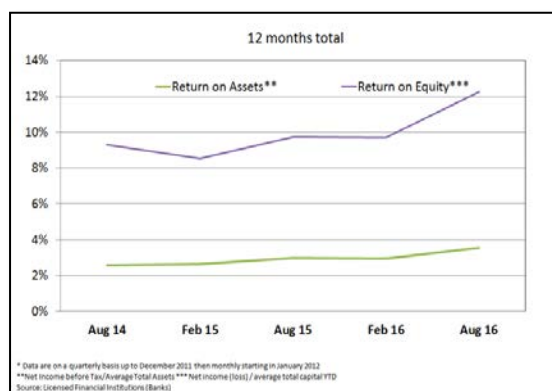
represented a Return on Assets<sup>3</sup> (ROA) of 3.5%, an increase from 2.9% in February 2016 and 3.0% in August 2015. Using Net Profit After Tax, the ROA rose to 2.6% in August from 2.2% in both February 2016 and August 2015. The Return on Equity (ROE) also increased to 12.3% compared to 9.7% in both February 2016 and August 2015.

Figure 27: Total Banking System's Profitability



The improvement in profitability over the past six months was due mainly to a decline in non-interest expenses. Non-interest expenses fell to 3.6% of average assets from 4.3% in February 2016 due mainly to a decrease in outsourcing and management fee expenses.

Figure 28: Total Banking System's ROE & ROA



Depreciation also declined over the past 6 months to August 2016 due mainly to lower non-financial assets such as premises and equipment. This was partly offset by a decline in non-interest income to 3.6% of average assets from 3.8% in February 2016, which was largely due to a decline in income from foreign

<sup>3</sup> Return on Assets = Net Profit Before Tax / Average Total Assets

exchange, as well as income from service charges, transaction fees & commissions.

The liquidity position of the banking system continued to remain comfortably above the minimum liquidity requirements during the six months to August 2016. Furthermore, the capital position of the banking system remained strong as healthy profits were recorded by the banks. The total risk-weighted capital ratio remained above the minimum ratio required by the NRBT of 15% at 33.2% at the end of August 2016, declining from 37.2% in February 2016 and 38.8% in August 2015. The decline reflects the rising risk weighted assets as banks' total loans grew over the six months to August 2016.

Figure 29: Total Banking System Asset Quality Indicators



The overall quality of the banks' assets (loan portfolio) continued to be closely monitored over the six months to August 2016 even though there was an improvement in the level of non-performing loans to a more manageable level compared to previous years. Total non-performing loans decreased by \$8.7 million (34%) to \$17 million over the past six months to August 2016, representing 4.8% of total loans, compared with 7.7% six months ago, and 8.7% in August 2015. This was due mainly to the settlement and write-off of business loans since February 2016. The bulk of the non-performing loans are business loans at 58.3%, which are mainly from the Hotel and Restaurants sector at 17.1%, Professional and Other Services at 13.6%, Construction at 9.4%, Agricultural sector at 7.7% and Manufacturing sector at 2.5%. Furthermore, non-performing housing loans were at 26.6% of total non-performing loans. There are adequate provisions held

against the non-performing loans with coverage ratio at 88.2%, rising from 66.5% in February 2016. About 68% of the total loan portfolio are secured by land, which are mainly housing and business loans.

### Outlook

The NRBT's credit growth forecast for 2016/17 was revised upwards from 11% to 15%, which is higher than the IMF Article IV projection of 10.8% for 2016/17. The NRBT's policy measures that was effective on 1st July 2016 which set a minimum requirement on banks' loans/deposit ratios to encourage further lending, should support the anticipated continued growth in credit and broad money. The NRBT's initiative to encourage lending to Micro, Small and Medium Enterprises is also expected to contribute to credit growth. At the same time, it is important for the structural reforms in different sectors as well as other impediments to lending such as the improvement to the land administrative system and the bankruptcy laws to improve the confidence of the banks to lend further in a prudent manner. NRBT is currently exploring ways to enhance the role of the credit bureau in Tonga and take up ownership and management of the system itself.

The NRBT in its liaison program with the Ministry of Infrastructure and Tourism found easier access to housing loans with banks' housing loan campaigns as well as the introduction of the home improvement loan at the Retirement Fund Board (RFB), which supports the forecasted 6 monthly increase. The banks' prospects for credit growth remain positive and the NRBT's projection is supported by the continuous improvements in business confidence, improving economic conditions and annual events.

Broad money is also projected to increase in June 2017 by 14%, up from 10% previously projected, supported by the anticipated rise in lending and foreign reserves. This is higher than the IMF Article IV's projection for broad money to rise by about 9% in June 2017.

### Supervision of Non-Bank Financial Institutions (NBFIs)

The supervision and oversight of all non-bank financial institutions remains work in progress. The legislations for the supervision of money lenders, credit union, microfinance institutions and foreign exchange dealers have been approved by Cabinet and are being processed to be submitted to the Legislative Assembly in early 2017. The Reserve Bank is aware of the concerns of over regulating the NBFIs particularly as they are serving certain sectors of the economy or community whom are not serviced by the banks. However the Reserve Bank would like to ensure 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 is of the opinion that the regulation of insurance companies, retirement funds and microfinance institutions are important to minimise 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 NRBT's regulatory and enforcement powers. The NRBT is also developing a Financial Consumer Protection policy pursuant to section 59B(2) of the NRBT (Amendment) Act 2014 to enhance the protection of financial consumers and thereby maintain confidence in the financial system. Work is also in progress to register and stock take all the NBFIs operating in Tonga while awaiting the approval of the legislations.

The financial system continued to be affected by the banks' de-risking decisions which have resulted in the closing of some of the foreign exchange dealers' accounts and the difficulty in securing correspondent banks for some banks due to elevated money laundering & terrorist financing risks associated with foreign exchange dealers and non-US correspondent and respondent banks. The NRBT continues to work together with the authorized restricted foreign exchange dealers to strengthen their Anti-Money Laundering/Counter Terrorist

Financing (AML/CFT) compliance status in order for the banks to retain their accounts. A report by the IMF in August 2016 has shown the cost of remittances from New Zealand to Tonga has increased as a result of de-risking. The banks and money transfer operators are being encouraged to develop alternative ways of transferring remittance such as online-based products that are low cost. New low cost products are being developed by some of the banks and are currently being tested before they are launched. Meanwhile, ANZ has reduced its remittance fees from New Zealand to Tonga to NZ\$7, and is planning on expanding this initiative to Australia. Similarly, MBf Bank has reduced its inward telegraphic transfer fees to T\$5 in an effort to reduce remittance cost to Tonga.

### **Financial Inclusion Initiatives**

The NRBT continues to promote financial inclusion in order to improve access to finance for all levels of the community, thereby promote inclusive economic growth. The NRBT through its membership of the Alliance for Financial Inclusion (AFI) has received monetary and technical assistance to promote the access of Micro, Small and Medium Enterprises (MSMEs) to finance and this project is in progress. This includes facilitating cooperation and coordination between the relevant stakeholders that contribute to developing the MSMEs. The NRBT also participated in knowledge exchange visits to Malaysia in May and Thailand in September to learn from their experience on how to improve the landscape for the development of MSMEs and their access to finance. These go towards formulating the strategies for the development of MSMEs and

promoting their access to finance. The development of MSMEs would play an important role in job creation, poverty alleviation, and promotion of exports and investment. The Supply Side Survey, which was conducted on the different financial service providers in Tonga, both banks and non-bank financial institutions, was updated in August 2016 with the latest information on the financial services that are available to financial customers. In addition, the report on the

Demand Side Survey, which was conducted on different individuals and households in Tongatapu and the outer islands, has been finalized to be launched in early 2017. The DSS provides the baseline level and condition of access and usage of financial services and products in the country. It has also identified the challenges and barriers that are faced by our people with regards to accessing financial products and services, as well as the type of products and services that are in demand. The outcome of the DSS also identifies the level of awareness and financial literacy of the people. The outcome of these surveys will assist the NRBT and relevant stakeholders with developing a National Financial Inclusion Strategy to promote financial inclusion in Tonga.

The Reserve Bank participated in various AFI working group meetings abroad during the last 6 months to August 2016, with the ultimate objective of improving access to finance.

## 6. Fiscal Indicators

The fiscal position has improved over the 6 months ended August 2016. Banking system data shows the net credit to government fell by \$17.7 million (36.6%) over the 6 months to August 2016, compared to a \$1.4 million (3.0%) decline in the 6 months to February 2016. This was driven by a \$20.4 million (29.6%) rise in government deposits, which reflected higher government receipts during the past 6 months to August 2016. The receipt of the budgetary support and grant funds before the end of 2015/16 financial year largely contributed to this increase.

In addition, government may have collected more from imports duty, consumption tax, excise tax and other related services fees in the past 6 months. This is evident in the rise in the container registrations by 127 containers (2.6%) and the increase in vehicle registrations by 165 vehicles (11.0%). The enforcement of the amendments to the excise tax and customs duty on 1<sup>st</sup> July 2016 may have also contributed to higher collection since July. Furthermore, government bonds issued during the past 6 months has resulted in a \$2.6 million (10.9%) rise in the banks' holdings of government bonds contributing to higher credit to government but was partially offset by the increase in government deposits.

Over the year to August 2016, net credit to government also fell by \$19.1 million (40.7%) due to a \$26.6 million (39.9%) rise in government deposits. The 2016/17 government budget indicates a fiscal balance of \$12.1 million of net borrowing, which the budget statement has indicated to be funded mainly from external sources. The Government is projected to borrow \$15.9 million through commercial borrowing, to provide budget support and funding for a few infrastructure projects. The government also expects to issue government bonds of \$4 million during the year, where \$3.5 million is to pay off the transfer value owed by the government to the RFB, and \$0.5 million is to support the government development fund loan scheme which is currently administered by the TDB. The new government bond of \$4 million was issued

in August 2016 for 5 years at 3%, and it was fully subscribed.

Budget support funds of \$30.4 million are also anticipated to be received in 2016/17 from development partners. About 31% of the total budget support is expected to be received from the Asian Development Bank, 25% from the Australian Department of Foreign Affairs and Trade (DFAT), 20% from the European Union, 13% from the World Bank and the remaining 12% from the Ministry of Foreign Affairs and Trade (MFAT), New Zealand. Total budget support received in the year to June 2016 was \$33 million, which was \$1.7 million less than the revised estimate of budget support. This contributed to the increase in the foreign reserves in 2015/16.

Tonga maintained its debt rating at moderate risk of external debt distress, and its external debt continued to increase as a result of the 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 2017 represented 52.1% of GDP, of which 45.5% is external debt and 6.6% is domestic debt. Total debt service for 2016/17 is to remain at over \$20 million where majority of this debt service is projected for external loan repayments. 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. External debt service is anticipated by the NRBT to remain at over \$10 million for the next fiscal year, and then increase significantly to \$28.2 million in 2018/19, reflecting the first principal repayment for the Nuku'alofa Central Business District loans in September 2018, followed by the commencement of principal repayment for the Road Project in 2019/20, both to EXIM Bank of China. This will put pressure on the level of foreign reserves. The EXIM Bank of China remained the main external debt creditor hence the Chinese renminbi has the highest share of the total external debt portfolio.

There were no new revenue measures in 2016/17, following the introduction of new

initiatives in 2015/16. This includes expansion of the private sector initiatives (loan scheme managed by TDB), amendments to the customs duty and excise tax for specific goods, zero percent rating of duty on healthy imported food, additional import duty of 15% on imported beers, spirits, cigarettes and tobacco products. The Customs Duty Amendment and Excise Tax Amendment came into effect on 1<sup>st</sup> July 2016 where new tariffs imposed mainly on unhealthy imported food, for items such as mutton flaps, chicken, mayonnaise, turkey tail and ice cream. On the other hand, import duty rates have been reduced to zero for some commodities to promote healthy living, to support local manufacture of water bottles and plastic water tanks, to support infrastructure development, and to encourage participation of the public in sports and other physical activities.

According to the NRBT's liaison program with the Ministry of Infrastructure and Tourism, there has been a change in the schedule of construction works to the Pacific Games.

These construction activities support the NRBT's forecast for continuous strong growth in the construction sector in the years to come.

Going forward, it is anticipated that Government receipts will increase in the near term from a rise in public debt due to the receipts of budget support and the increase in revenue collections from the introduction of the foreign exchange transaction levy as well as the amendments to the customs duty and excise tax. The higher receipts of budget support would contribute to the NRBT's projection for foreign reserves to remain comfortably above the minimum range to June 2017.

Net credit to the government is also expected to fall due to anticipated budgetary support and government grants receipts. Government spending however is anticipated to increase in the near term which will reduce government deposits thereby partially offset the expected fall in the net credit to government. NRBT will closely monitor the implication of the fiscal policy measures on the monetary policy objectives.

## 7. Monetary Policy Stance

In the past six months to August 2016, the NRBT maintained its current accommodative monetary policy stance. Although the annual headline inflation started to pick up in August, foreign reserves were at a comfortable level above the minimum range of 3-4 months of import cover; exchange rates were competitive; the financial system remained sound as it maintained strong capital and liquidity positions, weighted average interest rates narrowed; and the domestic economy grew strongly as expected.

The NRBT anticipates the annual headline inflation rate to be above 6% in the remaining months of 2016 and to fall to around 4% in the beginning of 2017/18. Foreign reserves is expected to remain above the 3-4 months of import cover. The banks' loans/deposit ratio remained below NRBT's minimum floor of 80% effective from 1st July 2016 which indicates that there is excess liquidity in the banking system. Furthermore, the outlook is for the economy to grow strongly. The current accommodative monetary policy stance is therefore considered appropriate in the medium term. The focus of the monetary policy is to encourage the utilization of the excess liquidity through higher prudent lending while minimizing upward pressure on the lending interest rates. This would include the promotion of the financial inclusion initiatives to improve access to finance. The supervision of banks and non-bank financial institutions are to be also strengthened to maintain financial stability and ensure the protection of financial consumers. At the same time, the NRBT will remain vigilant and closely monitor early signs of vulnerabilities, as the 2016 IMF Article IV mission had recommended.

The following policy actions are being taken by the NRBT to enhance its role in promoting macroeconomic and financial stability:

- ✓ The NRBT has introduced a policy measure effective on the 1st of July, 2016 to encourage credit growth by setting minimum requirements on the banks' loans to deposit ratio in order to encourage the banks to utilize the excess

liquidity in the banking system by prudently lending to the banks. The banks are expected to meet the minimum range of 80% loan to deposit ratio by December 2016, 85% by June 2017, and 90% by December 2017.

- ✓ Legislative amendments and new laws are being processed to implement the NRBT (Amendment) Act 2014 that had broadened the scope of supervision to non-bank financial institutions. This would strike a balance in promoting the NBFIs' activities and protecting their customers' interests. A number of draft Bills have been submitted for processing with the Attorney General's Office, being -

1. Microfinance Institutions Bill
2. Moneylenders Bill
3. Credit Unions Bill
4. Foreign Exchange Control (Amendment) Bill
5. Banking Bill – renaming of the Financial Institutions Act as Banking Act, and other amendments to strengthen the controllership & receivership provisions and corrective measures
6. National Reserve Bank of Tonga (Amendment) Bill

Legislation to regulate pension funds and insurance are currently being drafted and a draft policy for financial consumer protection is currently being reviewed by the Board.

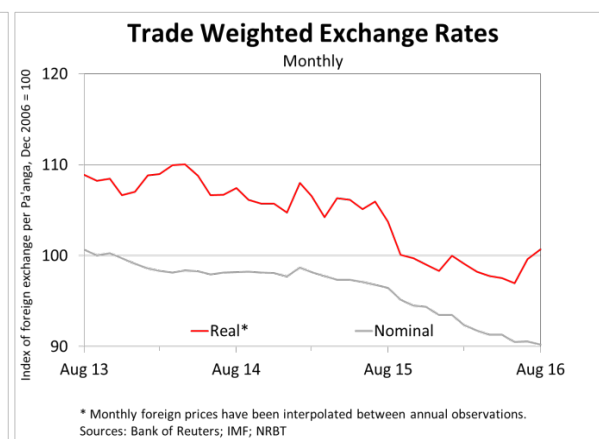
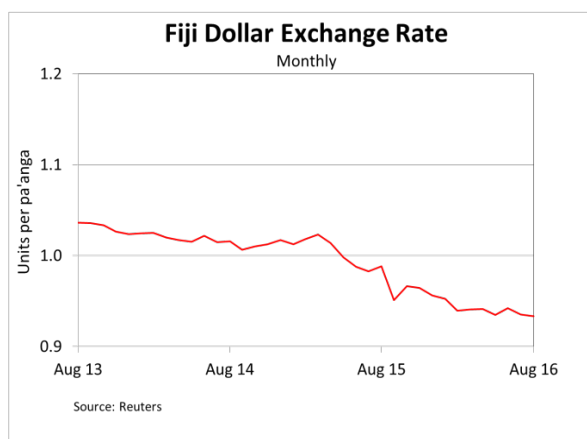
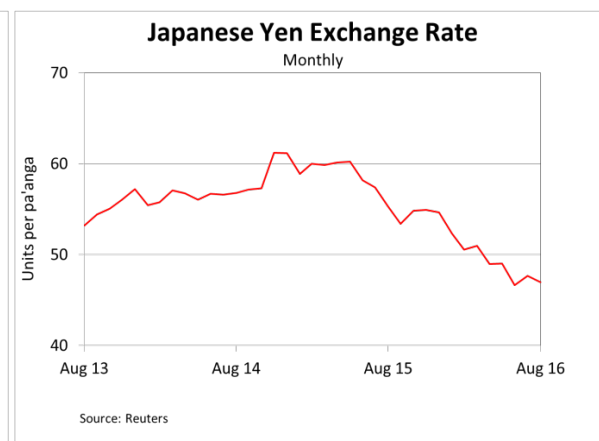
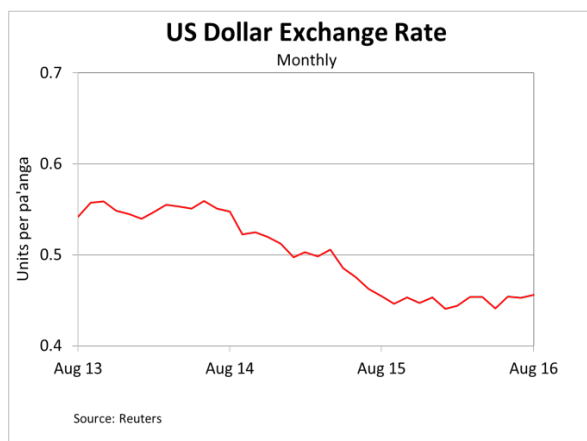
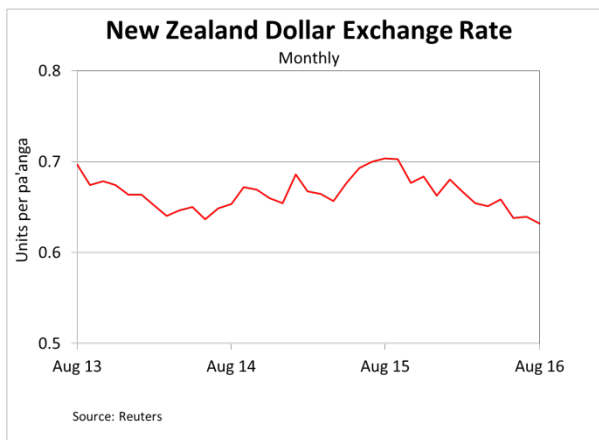
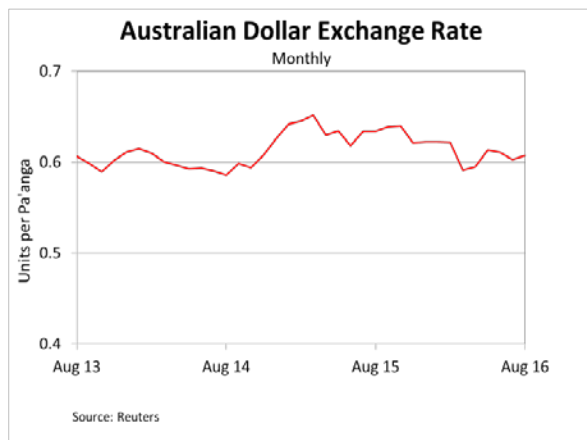
The Reserve Bank had sought feedback from the International Monetary Fund (IMF) and the Asian Development Bank on the amendment to the Foreign Exchange Control Act. The IMF has confirmed that the Bill is in compliant with the IMF's Article VIII that relates to foreign exchange restrictions.

- ✓ The NRBT continues to promote financial inclusion initiatives to support inclusive economic growth, including improving access to finance by Micro, Small and Medium Enterprises.

- ✓ The Reserve Bank is currently exploring ways to enhance the role of the credit bureau in Tonga and take up ownership and management of the system itself. The Financial Institution (Amendment) Act 2014 included regulation and supervision of the Credit Bureau. International Finance Corporation is assisting and will shortly release a drafted template to change from negative to positive reporting and draft template for legislation and or regulation of credit bureau. The template is based on the General Principles for Credit Reporting from the Bank for International Settlements 2011.
- ✓ NRBT is liaising with key stakeholders in November 2016 to discuss the possibility of a more market based financial market and an effective monetary policy transmission mechanism to achieve this goal.

The NRBT will closely monitor the country's economic and fiscal developments and financial conditions to maintain internal and external monetary stability, and 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.