
National Reserve Bank of Tonga

Annual Report for the Year Ended 30 June 2007

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Discrepancies between the sum of the constituent items and the total, as shown in some tables, are due to rounding.
Revisions to previously published statistics are included as they occur.

Governor's Forward

The Tongan economy showed considerable resilience over 2006/07 in the face of substantial economic shocks. Significant increases in public service salaries paid in two tranches over the past two years, as well as large scale redundancies, placed considerable strains on inflation and the government's fiscal balance. Furthermore, the civil unrest in November 2006 threatened the macroeconomic stability of the country with the destruction of around 20 percent of Tonga's GDP. The Ministry of Finance forecasts economic growth to have contracted in 2006/07 by 3 to 4 percent. Ongoing record prices of imported commodities, particularly oil, added to the internal shocks, while appreciations in the New Zealand and Australian dollars placed further upward pressure on imported inflation. The culmination of these events presented major challenges to the conduct of monetary policy.

I am pleased to report that despite these many challenges, the external balance of the country continued to improve, stability and confidence in the financial sector was maintained and inflation eased. The level of official foreign exchange reserves remained above 4 months of import cover throughout 2006/07 and average inflation fell to 5.1 percent, the lowest level in 7 years. Beyond 2006/07, a moderate pick-up in activity is expected, underpinned by increased construction spending. It is pleasing to note that growth in lending for business investment is already gathering momentum.

The financial year began with growth in household credit continuing at an unsustainable pace, albeit well below the growth in 2005/06. Credit ceilings, introduced in January 2006, were extended to December 2006, allowing for an expansion of credit that was consistent with the protection of foreign exchange reserves and macroeconomic stability. However, the civil unrest of 16 November 2006 dramatically changed the economic outlook, therefore the Reserve Bank refocussed its policy measures to maintain monetary and financial sector stability. Amid the crisis, the Reserve Bank liaised on a daily basis with the banks to ensure that the public's requirements for currency were effectively and securely satisfied. Foreign exchange guidelines were tightened and the quality of banks' loan portfolios was closely monitored. In February 2007, the credit ceilings were suspended, allowing affected businesses to have greater access to funds for reconstruction. Liquidity in the banking system nevertheless remained constrained and in April, the Reserve Bank reduced the required reserves ratio of commercial banks from 12.5 percent to 10 percent, resulting in an injection of T\$6.2 million into the banking system. Monetary policy has since remained accommodative, with the Reserve Bank choosing to leave excess liquidity in the banking system by refraining from issuing Reserve Bank notes in order to facilitate reconstruction.

In an important milestone in the development of Tonga's financial system, The National Reserve Bank Amendment Bill 2007 was passed by the Legislative Assembly in August 2007 after being deferred in 2005. This Act will strengthen the institutional capacity of the Reserve Bank and ensure greater autonomy in the conduct of monetary policy. The Act also strengthens the accountability and transparency of the Reserve Bank in exercising its powers. The Reserve Bank will be required to publish every six months a Monetary Policy Statement; the first Statement was published in September 2007. The release of regular Statements on Monetary Policy mean that commentary relating to the conduct of monetary policy will no longer be included in the Annual Report as in previous years.

Separate to the Act and to further enhance accountability and transparency, the Reserve Bank reviewed its policies and procedures relating to liquidity management and in October 2006 commenced publishing daily liquidity data on its website. In December 2006, the terms and conditions of the Reserve Bank's Repurchase Agreement facility were revised and the repurchase agreement rate was set at 2 percent above the inter-bank market rate.

Substantial progress was also made in enhancing accountability and transparency within the wider financial system. The release of Prudential Statement No. 3, relating to administrative penalties, which became effective in September 2006, is designed to ensure the timely and accurate provision of data by banks, a vital prerequisite for sound economic and financial decision making. Furthermore, the release of Prudential Statement 4, Disclosure of Interest rates and Fees and Charges, requires banks to fully disclose the cost of their services and products and became effective in August 2007. This Prudential Statement was prepared after consultations with the newly-formed Association of Banks in Tonga (ABT), an initiative that was welcomed by the Reserve Bank. The establishment of the ABT in April 2007 is expected to provide an important forum for the discussion of issues that can only enhance the effectiveness and efficiency of the financial system.

Despite the unexpected crisis of November 2006, which interrupted the implementation of the 2006/07 workplan, the Reserve Bank successfully completed its target to update the documentation of the Bank's policies and procedures together with staff job descriptions. The Reserve Bank continued to carry out its regular functions that contribute to monetary and financial sector stability. These functions include the supply of Tongan currency, provision of daily settlement for inter-bank transactions, foreign exchange operations with the government and the banks, foreign exchange control administration and registrar of government bonds.

The Reserve Bank continued to develop the skills base of its staff, through local and overseas training. Staff participated in courses across the range of central banking functions, including bank supervision, reserves management, remittances, anti-money laundering, balance of payments reporting and information technology.

The annual accounts of the National Reserve Bank of Tonga comply with the requirements of the International Financial Reporting Standards, with the exception of the treatment of foreign currency gains and losses, which meets the provisions of the National Reserve bank of Tonga Act, 1988. The Reserve Bank's balance sheet expanded to T\$133.4 million, a 6.4 percent increase from the previous year attributed mainly to the increase in the level of official foreign reserves over the year. Consequently, the Reserve Bank's operating profit, reached T\$3.6 million, an increase of 14.5 percent over the previous year.

I thank the staff of the Reserve Bank for their efforts during a very challenging period for the Reserve Bank and the Tongan economy. I also thank the government and members of the financial sector for their part in ensuring that confidence and stability in the system was maintained. Appreciation is also extended to the members of the Bank's Board for their continued support during the year. The assistance from the International Monetary Fund, Pacific Technical Assistance Centre, the Reserve Banks of Australia, New Zealand and Fiji, other regional central banks, the Bank of England Centre for Central

Banking Studies, AusAID, NZAid, AUSTRAC, AMLAT and the Pacific Antimoney Laundering Project is also gratefully acknowledged.



Siosi C. Mafi

Governor

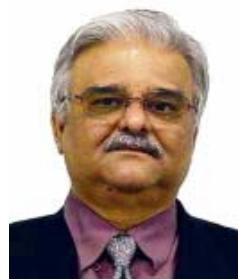
Board of Directors of the National Reserve Bank of Tonga as at 30 June 2007



HRH Princess Salote Pilolevu Tuita
Acting Chairperson



Hon. Siosiua T. T. 'Utoikamanu
Minister of Finance



Mr. Richard Prema



Mrs. Siosi Cocker Mafi
Governor

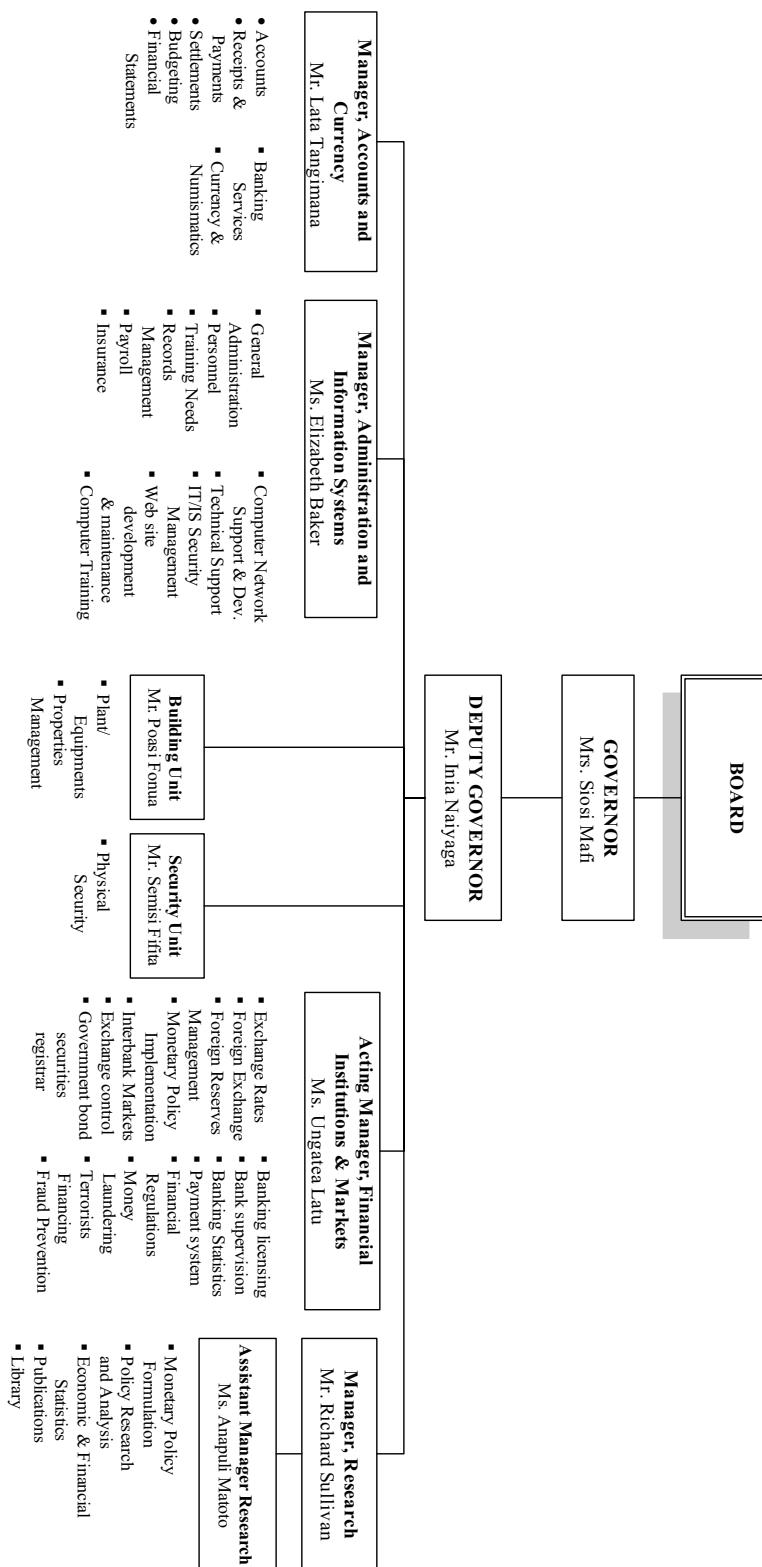
Principal purposes of the National Reserve Bank of Tonga

“The principal purposes of the National Reserve Bank of Tonga shall be:

- (a) to regulate the issue of currency, and the supply, availability and international exchange of money;
- (b) to manage the external reserves of the Kingdom;
- (c) to promote monetary stability;
- (d) to promote a sound financial structure;
- (e) to foster credit and exchange conditions conducive to the orderly and balanced economic development of the Kingdom;
- (f) to provide advisory services to the Minister on banking and monetary matters;
- (g) to be the principal banker and fiscal agent of the Government;
- (h) to undertake banking business, in Tonga or elsewhere, subject to the provisions of this Act;
- (i) to undertake the licensing and supervision of financial institutions.”

Section 4
National Reserve Bank of Tonga Act, Cap 102

NATIONAL RESERVE BANK OF TONGA
June 2007



Contents

Economic Overview	
Overseas Economic Developments	1
Domestic Economic Conditions	2
Prices	3
Financial Intermediation	4
Interest Rates	4
External Developments	5
Economic Outlook	6
Financial Markets	
Open Market Operations	8
Reserves Management	8
Foreign Exchange Operations	9
Exchange Control Operations	9
Registrar of Government Bonds	10
Export Finance Liquidity Facility	10
Financial Institutions	
Financial Sector: Facilities and Operations	11
Financial Performance	12
Liquidity	13
Capital	13
Asset Quality	14
Supervision of Licensed Financial Institutions	14
Transaction Reporting Authority	15
Operations of the Reserve Bank	
Currency Operation	16
Financial Performance	17
Information Systems and Technology	17
General Administration	17
External Relations	19
Board of Directors	19
Senior Officers	21
Financial Statements	
Directors' Report	24
Statement by Directors	27
Independent Audit Report	28

Contents

Income Statement	30
Balance Sheet	31
Statement of Changes in Equity	32
Statement of Changes in Cash Flows	33
Notes to and Forming Part of the Financial Statements	34

List of Figures

<i>Figure 1 : Gross Domestic Product (average annual percent change)</i>	2
<i>Figure 2 : Consumer Prices (year-ended percentage change)</i>	4
<i>Figure 3 : Banking Sector Liquidity and Private Sector Credit</i>	4
<i>Figure 4 : Weighted Deposit Interest Rates</i>	5
<i>Figure 5 : Financial Sector – Components of Operating Income</i>	13
<i>Figure 6 : Financial Sector – Components of Total Operating Expenses</i>	13
<i>Figure 7: Financial Sector – Non Performing Loans - Coverage Ratio</i>	14

List of Tables

<i>Table 1. International Economic Indicators</i>	1
<i>Table 2. Tonga Main Economic Indicators</i>	3
<i>Table 3. Overseas Exchange Transactions (OET): Annual Summary</i>	6
<i>Table 4. Financial Sector Accounts</i>	11
<i>Table 5. Financial Performance</i>	12

Economic Overview

Overseas Economic Developments

The strong global expansion continued through the past year, with world economic activity estimated to have grown by 3.8 percent in 2006. The outlook is for the world economy to maintain solid growth through 2007 and 2008. Although growth in the United States slowed in the first half of 2007, activity is expected to expand strongly elsewhere. China and India are projected to once again record rapid growth, while above-trend levels of growth are expected in Japan and the Euro zone. Australia and New Zealand are expected to post economic growth at around trend.

The strong growth in China in particular has led to strong demand for industrial inputs, pushing input prices up throughout the world. In turn, inflation rose in most countries through 2006, prompting tighter monetary conditions in China, Japan, Australia, New Zealand, the United Kingdom and the Euro zone. Of Tonga's main trading partners only the United States did not increase interest rates in 2006/07. The outlook is for consumer prices to remain generally well contained, though with less upward pressure as China's attempts to curb growth appear to have some success stemming the upward pressure on industrial inputs prices.

Table 1 : INTERNATIONAL ECONOMIC INDICATORS

	Real GDP			Consumer Prices			Current Account Balances		
	Annual percent			Annual percent change			Percent of GDP		
	2006	2007	2008	2006	2007	2008	2006	2007	2008
United States	2.9	1.9	1.9	3.2	2.7	2.3	-6.2	-5.7	-5.5
Japan	2.2	2.0	1.7	0.3	0.3	0.5	3.9	4.5	4.3
Euro area	2.8	2.5	2.1	2.2	2.0	2.0	-0.3	-0.2	-0.4
China	11.1	11.5	10.0	1.5	4.5	3.9	9.4	11.7	12.2
Australia	2.7	4.4	3.8	3.5	2.3	2.8	-5.5	-5.7	-5.6
New Zealand	1.6	2.8	2.3	3.4	2.4	2.7	-8.7	-8.5	-8.6

Source : IMF World Economic Outlook, October 2007

Global financial markets saw bond yields rise in response to expectations of ongoing global growth and for monetary policy to remain firm. Since the end of June 2007, an unwinding of 'carry-trades' and widespread defaults of sub-prime mortgages in the United States have seen bond yields fall as demand for safe-haven investments drives down yields.

Growth in the United States slowed significantly in 2006/07 as the soft housing market showed no signs of recovering and high energy prices continued to constrain industrial production. The Federal Reserve maintained the Fed Funds Rate at 5.25 percent throughout the year as worries about inflation offset weaker growth. Growth is expected to pick up in the second half of 2007, as business investment picks up. However, residential investment continues to show marked weakness and the recent sub-prime market turmoil has shown high indebtedness among poorly-rated borrowers. The ensuing turbulence in financial markets has swayed the Federal Reserve to look at easier monetary conditions despite ongoing inflation concerns.

Double-digit growth continues in China with exports rising rapidly, though the expansion is broadly-based. Concerns that the economy is overheating are mounting, and while inflation is well contained expectations are rising. China's authorities have regularly tightened financial conditions in an attempt to rein in activity, raising benchmark interest rates and reserve requirements for banks.

Japan's economy grew by 2.3 percent in the year ended June 2006, with a pick-up in domestic demand driving growth. Growth in the coming year is expected to be at about the same rate as industrial production and exports pick up. With the outlook for inflation to be above zero in the future, interest rates are also expected to rise further, following the end of the zero-interest rate policy last year. Elsewhere in Asia, growth is to be above trend, according to the latest Consensus Forecasts.

Australia's impressive economic expansion continues and heads into its 15th consecutive year. A massive boost to Australia's terms of trade from the industrial commodities boom has lead to an increase in business investment that is expected to remain strong. The long period of growth is starting to show in capacity constraints with unemployment at historically low levels. As such inflationary pressures remain and despite holding rates steady for much of the last year, the Reserve Bank of Australia has resumed its tightening cycle with further monetary tightening expected before the end of 2007.

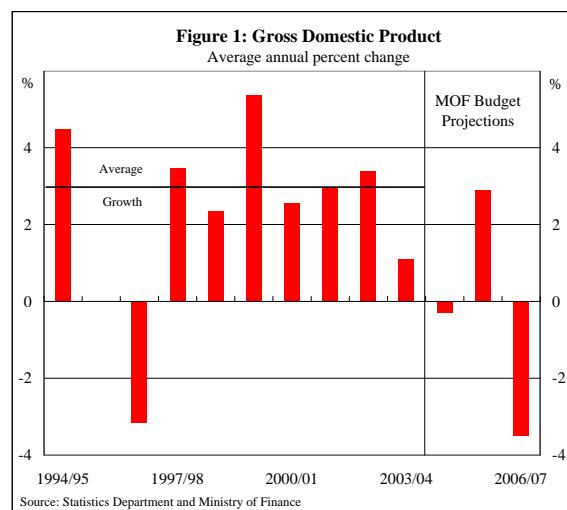
Similarly, New Zealand has experienced a terms of trade boost through high export commodity prices. Along with a very resource stretched domestic economy, a persistently strong housing market and high imported input costs, inflation remains of concern to policy makers. Four rate increases over the last year appear to have finally taken the heat out of the housing market, and a period of slower growth is expected. A lower New Zealand dollar will increase imported inflation concerns and the Reserve Bank of New Zealand is unlikely to ease monetary policy over the next year.

The Pacific region has seen mixed economic fortunes over the past year. Political turmoil in Fiji and the Solomon Islands have undermined those economies to greater or lesser extent. Fiji has experienced a large fall in tourism receipts, compounding the reduction in exports from a poor agricultural season. Investment and manufacturing are also subdued. In contrast, the civil unrest in Solomon Islands seemed to have had only a small impact on the economy there. High industrial commodity prices are supporting the mining industries there. Likewise Papua New Guinea benefits from its resource rich mining sector. In Samoa, a construction boom in preparation for the South Pacific Games boosted the economy and ongoing growth in tourism has seen the economy grow robustly.

Domestic Economic Conditions

Economic growth was estimated by the Ministry of Finance to have fallen from 2.9 percent in 2005/06 to a contraction of 3.5 percent in 2006/07, which is the lowest rate of growth in the past ten years (Figure 1).

Agricultural output, which comprises nearly a quarter of GDP, again fell, though by less than in 2005/06. For the first six months of 2006/07, trade data suggests that production of squash, Tonga's main cash crop, as well as root crops, vanilla and nonu were subdued. Kava on the other hand made positive contributions to agricultural exports from Tonga. Output from fishing and other marine products rose as live and fresh fish exports recovered positively, more than offsetting the low export from agriculture sector.



Moderate growth in construction activity is estimated, as most of the arrangements in insurance and loan relief for rebuilding of the Nuku'alofo Central Business District (CBD) are still progressing. Household sector construction was also subdued after slower growth in housing credit during the financial year 2006/07.

The commerce, hotels & restaurants sector, which includes retailing and wholesaling, as well as many tourist activities fell in 2006/07, reflecting the destruction of nearly 80 percent of the Nuku'alofo CBD. However it is expected to pick up again after the reconstruction and settlement of insurance claims. Surveys conducted by the Reserve Bank reported moderate growth in vehicle sales.

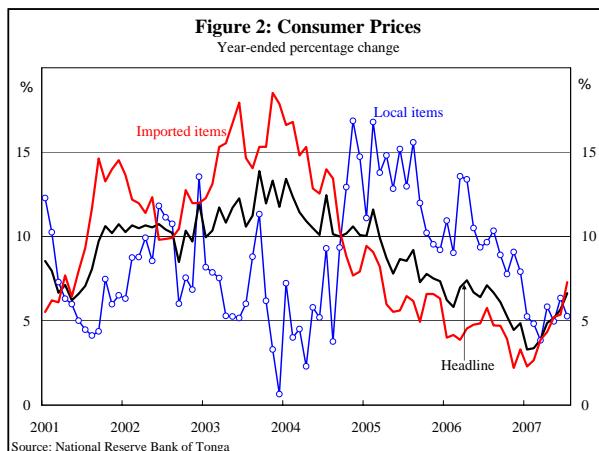
Total visitor arrivals to the Kingdom, which includes air and cruise ship arrivals, declined last year, for the first time in 5 years.

Table 2. TONGA MAIN ECONOMIC INDICATORS					
		2003/04	2004/05	2005/06	2006/07
Economic Activity (1995/96 base)					
Real GDP	% change	1.1	-0.3	2.9	-3.5
Tourist Air Arrivals	thousands	43.6	51.9	53.3	52.8
Money, Prices & Interest Rates					
CPI (average)	% change	11.8	10.0	7.2	5.1
CPI (year-end)	% change	10.1	8.7	6.4	5.7
Money Supply (M2 - year end)	\$m pa'anga	180.3	203.5	237.3	265.5
Domestic Credit (year end)	\$m pa'anga	174.0	210.3	264.5	295.2
Weighted-term deposit interest rates (year end)	% per annum	6.5	6.0	6.8	6.6
External Sector					
Merchandise exports fob (OET basis)	\$m pa'anga	28.3	31.1	31.9	26.7
Merchandise imports fob (OET basis)	\$m pa'anga	169.0	204.2	245.4	217.5
Official foreign reserves (year end)	\$m pa'anga	89.7	82.1	83.2	91.6
Import coverage (year end)	months	5.4	4.4	4.3	4.4
Exchange rate (period end)	US\$/T\$	0.5	0.5	0.5	0.5
Sources: Ministry of Finance Budget 2007/08, Ministry of Tourism, Statistics Department and National Reserve Bank of Tonga					

Prices

Headline inflation as measured by the Consumer Price Index (CPI) continued to slow in 2006/07. The CPI rose by 5.7 percent in the year ended June 2007, down from the 6.4 percent rise in year ended June 2006 (Figure 2). Average annual inflation in 2006/07 was 5.1 percent, down from 7.2 per cent in the previous year and also below the IMF forecasted average annual inflation rate of 10.3 per cent. The decline in the rate of inflation was mainly due to a slowing of price increases of domestic goods.

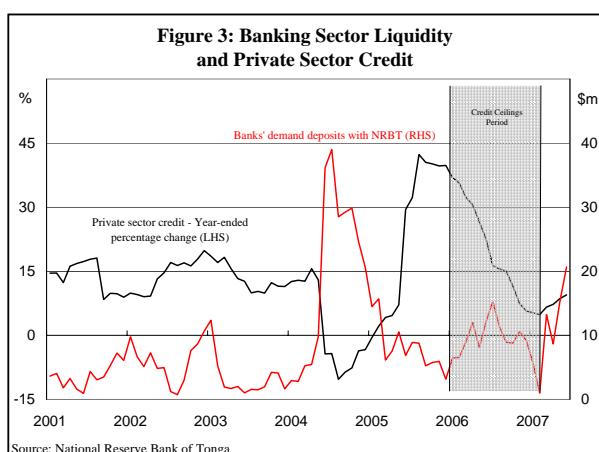
Domestic inflation increased at lower rate of 6.3 percent during the year ended June 2007, compared with a 9.4 percent increase in the previous year. The fall in domestic inflation reflected a fall in transportation prices by 0.4 percent compared to an 18.7 percent increase recorded in the previous year. The decline in transportation prices reflected a fall in world oil prices in early 2007. Other categories that contributed to the slowing inflation rate include clothing and hardware, tobacco and alcohol, and housing. Household operation prices recorded a rise of 15.5 percent and miscellaneous goods and services increased by 5.8 percent. Domestic food prices, notably fruits and vegetables, also recorded a fall due to favourable weather during the past year.



In contrast, the price of imported goods rose by 5.4 percent in the year ended 2007, compared with the 4.8 percent rise in the year ended June 2006. Food prices contributed the most with 2.7 percentage points to the annual inflation, reflecting New Zealand dollar appreciation against the Tongan pa'anga as more than half of the total imported goods are from New Zealand. Further, rises in overseas underlying inflation, particularly New Zealand and Australia over the year put pressure on prices of imported items.

Financial Intermediation

Total broad money (M3), a broad measure of money supply, increased by 13.3 percent in the year-ended June 2007, this level of growth is similar to June 2006 although it is a pick up in growth in the second half of financial year 2006/07. The suspension of the credit ceiling in February 2007 and the lowering of the Statutory Required Reserves Ratio in April 2007 are to assist with the anticipated pick-up in the demand for credit to support reconstruction after the civil unrest of 16 November last year (Figure 3).



Throughout the financial year 2006/07, lending by the banking system was mostly towards the business sector (19.4 percent year-ended growth) with household credit falling to a year-ended growth of 2.2 percent in June 2007 from 22.4 percent in June 2006. Most of the lending to households was for housing and to a smaller extent, other personal purposes. Business lending was broadly based across other services, wholesale & retail, manufacturing and transport & storage.

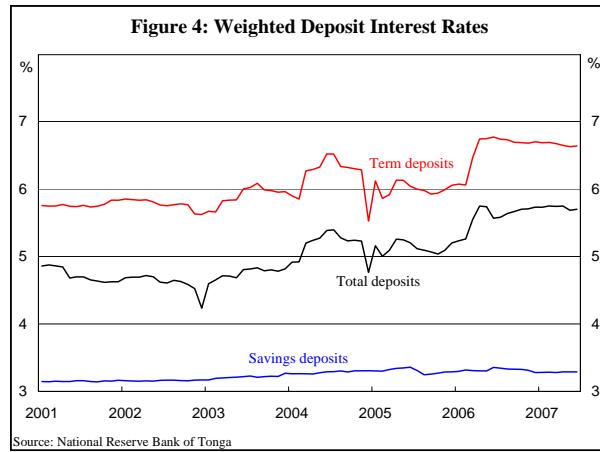
The increase in lending in 2006/07 was largely funded by a rise in term deposits and demand deposits, with term deposits increasing by 15.7 percent in the year ended June 2007. Saving deposits growth fell at the end of June, reflecting the one-off redundancy payments to retiring civil servants, being shifted into longer-term, higher yielding accounts.

The government continued to be a net lender to the banking system in the financial year 2006/07 accommodating the growth in credit to the private sector.

Interest Rates

Interest rates were relatively stable in 2006/07, reflecting high liquidity in the financial system. In the second half of 2006, financial conditions continued to tighten mainly reflecting the continuous strong growth in lending over the previous twelve months and lower-than-expected receipts from squash

exports. The payments of civil service redundancies and the second tranche of the civil service salary increase from government deposits with the banking system heightened the need for banks to increase their liquidity levels. This underpinned strong competition amongst the banks for funds. In the first half of 2007, the Reserve Bank eased its monetary policy stance by removing the credit ceilings imposed on lending to private sector to allow banks to consider lending for the recovery of those who were affected by the civil disorder of 16 November 2006. In addition, the Reserve Bank reduced the required reserves to inject additional liquidity into the banking system to assist with the anticipated pick-up in the demand for credit to support reconstruction. By the end of June 2007, the Reserve Bank's term deposit indicator rate, a weighted average of interest rates paid by commercial banks, fell to 6.6 percent from 6.8 percent a year earlier (Figure 4). The lending indicator rate, a weighted average of interest rates across household and business lending, was largely unchanged at 12.3 percent.



The increase in nominal interest rates and the fall in inflation resulted in real deposit interest rates moving to positive territory. The move towards positive real interest rates has encouraged savings in financial institutions, thereby enhancing financial intermediation and promoting an environment conducive to economic development.

External Developments

According to overseas exchange transactions data collected from the commercial banks, the deterioration in the current account deficit was offset by an improvement in net capital inflows, resulted in a rise in the level of official foreign exchange reserves (Table 3). The reduction in the trade deficit in 2006/07, reflected the substantial fall in imports, mainly consumer goods, since the civil unrest in November 2006, in which retail and wholesale businesses were greatly affected. The value of imports fell by \$27.9 million to \$217.5 million, consistent with the fall in private remittances and sluggish growth in credit to household sector over the year. Exports fell by \$4.3 million to \$26.7 million, largely reflecting lower export earnings from squash.

Net remittances, the main source of Tonga's foreign exchange earnings, fell by \$9.8 million to \$168.8 million in 2006/07, largely reflecting a fall in private transfer receipts and to a smaller extent a fall in private transfer payments. The deficit on the services account partly reflected a fall in tourist receipts as a result of the civil disorder of 16 November last year, while the net balance on investment income remained a modest surplus. These movements resulted in a widening of the current account deficit from around \$46 million to \$51 million or 11.1 percent of GDP.

The capital account surplus rose by \$8.5 million to \$53.8 million in 2006/07, reflecting an increase in official and private capital inflows. The improvement in the capital account together with the net unrecorded inflows more than offset the deterioration in the current account deficit, which resulted in a balance of payments surplus of \$8.4 million and a higher level of official foreign reserves. Gross official foreign reserves rose to \$91.6 million at the end of June 2007, an amount equivalent to 4.4 months worth of imports (Table 2).

Table 3. OVERSEAS EXCHANGE TRANSACTIONS (OET): Annual Summary

	2003/04	2004/05 ^{2/}	2005/06 ^{2/}	2006/07
A. Merchandise trade balance	-140.8	-173.1	-214.4	-190.8
Exports, f.o.b.	28.3	31.1	31.0	26.7
Imports, f.o.b.	169.0	204.2	245.4	217.5
B. Services balance	-5.9	-19.3	-15.7	-35.8
Receipts	52.7	45.9	50.9	38.8
Payments	58.5	65.2	66.6	74.7
C. Investment income balance	-0.8	3.1	5.7	7.1
Receipts	5.6	6.6	9.9	12.9
Payments	6.4	3.5	4.2	5.8
D. Transfers balance	163.1	178.1	178.4	168.6
Receipts	185.7	208.7	205.5	187.3
<i>Private</i>	184.4	208.1	205.0	186.8
<i>Official</i>	1.3	0.6	0.5	0.5
Payments	22.6	30.6	27.1	18.7
<i>Private</i>	21.9	30.0	26.5	18.1
<i>Official</i>	0.7	0.6	0.5	0.6
E. Current account balance (A+B+C+D)	15.7	-11.1	-46.1	-50.9
F. Capital account balance	75.6	24.2	45.3	53.8
Official capital	28.1	9.4	16.9	19.7
<i>Inflows</i>	33.1	16.2	22.8	24.7
<i>Outflows</i>	5.0	6.9	5.9	5.0
Private capital	47.5	14.9	28.4	34.2
<i>Inflows</i>	56.5	34.2	37.5	39.9
<i>Outflows</i>	9.0	19.3	9.1	5.7
G. Other items, net	-38.5	-20.7	1.9	5.5
H. Overall balance (E+F+G) ^{1/}	52.8	-7.6	1.1	8.4

1/ Corresponds to changes in gross official foreign reserves.

2/ Revised

Totals may not add up due to rounding.

Source: National Reserve Bank of Tonga

Economic outlook

The economic outlook for 2007/08 is highly uncertain. The Tongan economy has coped with major economic shocks in the past two years, and shown significant resilience. Unless further major economic shocks occur, activity should increase over the next year, but this brings with it risks of higher inflation and lower official foreign reserves. The expected increase in activity, especially in construction and related industries will be affected by the likelihood of long delays in receiving funding for reconstruction, both in terms of aid and insurance.

World markets for Tonga's main agricultural export, squash, are poor and likely to remain so for some time. Despite efforts to diversify the squash production into other varieties, agricultural output is likely to be subdued over the next year. Similarly, fishing exports are expected to be low. Tourism receipts will recover from the low base of the 2006/07 year when tourist receipts significantly fell due to the November 2006 civil unrest.

The trade deficit is anticipated to be larger in 2007/08 due to expected higher imports and stagnant exports. As such, higher net services, and net transfers and higher capital account surplus are required to minimize the adverse impact on the level of official foreign reserves and the balance of payments position. Business investment appears to be recovering well from the lows experienced at the end of 2006, with higher growth in new business loans recorded in the first half of 2007 rising from 16.1 percent over the year to February 2007, to 19.4 percent at the end of June 2007. This growth is expected to continue, underpinning domestic activity, and some capital inflows. Net transfers appear to be picking up from the low level in the first half of 2007, and private remittances receipts are expected to increase in the second half of the year in line with a number of significant events in Tonga such as the Heilala festival, Tonga High School 60th anniversary, consecration of the Coadjutor Bishop of the Catholic Church, Tonga College 125th anniversary, dedication of the newly renovated Tonga Temple of the Church of Latter Day Saints, large regional conferences including the 38th Pacific Islands Forum, rugby tournaments, and family and island reunions.

Inflation is expected to remain under significant pressure from two main sources. First, the continuing high international prices for oil and food. The high world oil prices will exert upward pressure on domestic prices directly through the price of fuel and indirectly through the price of oil-related services such as electricity, transportation, etc. Second, the continuing appreciation of the New Zealand dollar will put upward pressure on imported inflation given New Zealand is the main source of imports. These pressures are unlikely to dissipate quickly, and therefore domestic prices are expected to be adversely affected.

Given the above and the uncertainty of the outlook for the Tongan economy, the Reserve Bank projects that the level of official foreign reserves will decline to around 3 months of import cover by the end of June 2008.

Financial Markets

Open Market Operations

The Reserve Bank continued issuing Reserve Bank Notes, by tender to improve its ability to manage liquidity and enhance the efficiency of the banking system. The Reserve Bank concentrated on issuing 28 day Reserve Bank Notes by tender on a weekly basis at an average yield that is based on the latest published market rates which ranged between 4.65 percent and 5.0 percent per annum. However, since March 2007 there has been no issuance of Reserve Bank notes following the decision by the Reserve Bank to ease its monetary policy stance. This was to allow banks to consider lending for the recovery of those who were affected by the civil unrest in November 2006. Therefore, at the end of 30 June 2007, the outstanding Reserve Bank Notes was nil.

The National Reserve Bank of Tonga Act 1988 prohibits the Reserve Bank from making unsecured loans to any of its customers. Any borrowing from the Reserve Bank has to be secured by government bonds, NRBT notes or any other security specified by the Board. In order to improve the effectiveness and efficiency of its liquidity management function, the Reserve Bank reviewed its liquidity management policy and procedures in 2006/07. In October 2006, the Reserve Bank commenced publishing weekly liquidity data on its website and in December 2006, it revised the terms and conditions for its Repurchase Agreement facility for domestic banks. The repurchase agreement is to be arranged for a maximum period of 7 days with minimum amount of T\$50,000. The repurchase agreement rate was set at 2 percent above the inter-bank market rate or 10 percent per annum whichever is higher. As at the end of June 2007, the repurchase agreement rate was at 12 percent. In 2006/07, the Reserve Bank received one application and entered into a repurchase agreement transaction with one of the licensed financial institutions.

The Financial Markets department also monitors activities in the domestic inter-bank market. The record showed that inter-bank activities picked up during the 2006/07 financial year. Total loans of \$17.07 million were made during the year for maturities ranging from overnight to two months compared to total loans of \$12.35 million in the previous year. The increase in the total loans in the inter-bank market largely reflected the tight liquidity experienced by one of the licenced financial institutions. The interest rate charged by the banks for overnight loans increased to 10 per cent per annum in 2006/07 compared with 8 percent per annum in 2005/06.

Reserves Management

The Reserve Bank is required to maintain, within the limit of its powers, an external reserve at a level of at least 3 to 4 months of imports. During the year the gross official external reserves ranged between 4.0 months and 4.6 months of import cover. The level of gross external reserves ranged from \$80.6 million to a peak of \$91.6 million at the end of June 2007. At 30th June 2007 the total official external reserves at \$91.6 million was estimated to be 4.4 months of imports. This compares with the level of \$83.2 million at 30 June 2006, equivalent to 4.3 months of imports. This reflected the decline in the growth of imports since December 2006. After the events of November 2006, both annual total foreign exchange receipts and annual total foreign exchange payments declined with the fall in total payments outweighing the decline in total receipts. The maintenance of the level of official foreign reserves above 4 months of imports contributed to maintaining confidence in the financial system of the country after the civil disorder of November 2006.

The Reserve Bank holds the external reserves mainly in US dollars, Australian dollars, New Zealand dollars, pounds sterling, euro and IMF special drawing rights. In managing the external reserves, the Reserve Bank's policy is to obtain the maximum income commensurate with safety, liquidity and the maintenance of overall value. Accordingly, the external reserves are invested in deposits with international banks that have a minimum A rating by international credit rating agencies, government securities and deposits with central banks.

Foreign Exchange Operations

The Reserve Bank conducts foreign exchange operations with the domestic commercial banks in the intervention currency only, the US dollar. The Reserve Bank quotes daily buying and selling rates for the US dollar against the pa'anga. These rates generally form the basis of the commercial banks' publicly quoted foreign exchange dealing rates. The Reserve Bank also conducts foreign exchange operations for its other customers, and for its own account, in a range of currencies. The Reserve Bank was a net buyer in the spot foreign exchange markets during the year. Foreign exchange purchases of T\$92.9 million exceeded sales of T\$84.5 million giving a total foreign exchange turnover for the year of T\$177.4 million.

Exchange Control Operations

The Foreign Exchange Control (Amendment) Regulations 2000 assigns the authority over sending money and securities out of the Kingdom to the Reserve Bank. This authority includes licensing of foreign exchange dealers. The Reserve Bank has licensed two authorized restricted foreign exchange dealers under the Foreign Exchange Control (Amendment) Act 2000. These authorized foreign exchange dealers are the Fund Management Limited which operates Western Union and Rowena Financial Services Limited. Commercial banks are authorized dealers under their banking licence.

The Reserve Bank continued to liaise with the Ministry of Labour Commerce and Industries to ensure all companies and businesses that are currently accepting foreign exchange and making foreign exchange payments and transfers are licensed. Any entity that is engaged in buying and selling foreign exchange must be licensed by the Reserve Bank under the Foreign Exchange Control Act. During the year, the Reserve Bank had issued a public notice to retail shops regarding illegal exchanging of foreign currency without a licence.

The Foreign Exchange Control (Amendment) Regulations 2000 gives the Reserve Bank the administrative powers of the Foreign Exchange Control Regulations. The Reserve Bank's prior approval is required for all outward current transfers of T\$50,000 and above and all capital transfers irrespective of the amount. All outward current transfers of less than T\$50,000 have been delegated to the commercial banks and licensed foreign exchange dealers subject to the Reserve Bank's foreign exchange control guidelines.

Following the 16 November 2006 riots, the Reserve Bank, under the Emergency Power (Maintenance of Public Order) Regulations 2006, introduced a requirement for obtaining of the Reserve Bank's prior approval for the removal of cash of over T\$10,000 from the Kingdom. During 2006/07, the Reserve Bank received 10 applications for removal of cash of over T\$10,000, of which 7 were approved totalling T\$0.3 million. In addition, the Reserve Bank amended the exchange control documentary requirement guidelines to reduce the delegated limit to the commercial banks and authorised foreign exchange dealers on travel payments to T\$20,000 from T\$50,000.

The Reserve Bank processed 872 exchange control applications totalling T\$156.5 million (of which 9 percent were classified as capital transactions) compared to 649 exchange control applications processed in 2005/06 amounting to T\$140.3 million. The increase in exchange control applications may be attributed to the increase in awareness by the banks and the authorized foreign exchange dealers on the exchange control requirements in Tonga.

The Reserve Bank continued to hold meetings with customers to clarify and improve the understanding of its Exchange Control policies and requirements. This included joint meetings with the Tonga Chamber of Commerce, the Tonga New Zealand Business Association, the banks and authorized restricted foreign exchange dealers, as well as bilateral meetings with some large customers. The Reserve Bank also conducted quarterly technical meetings with the Revenue Services Department and Customs to coordinate efforts in ensuring the objectives of the Exchange Control policies and requirements are being achieved.

Registrar of Government Bonds

The Reserve Bank acts as registrar for all of the Government of Tonga's bond issues, the total value of which was \$24.7 million at 30 June 2007 compared to \$24.9 million in the previous year. The total value of government bonds declined towards the end of the year due to the payout of the government bonds which matured in June 2007. The Reserve Bank continued to seek to develop the domestic capital market in Tonga and is marketing its holdings of government bonds on its website. The Reserve Bank may also provide a secondary market for government bonds to increase or reduce liquidity in the banking system depending on the Reserve Bank's monetary policy stance.

Financial Institutions

The National Reserve Bank of Tonga Act, 1988 and the Financial Institutions Act, 2004 authorise the Reserve Bank to undertake the prudential supervision of the licensed financial institutions. The primary objectives of the Reserve Bank in this area are the stability of the financial system and the security of depositors' funds with licensed financial institutions.

During the year, there was no change to the composition of the financial system in Tonga which is three commercial banks, a development bank and the central bank.

Financial Sector: Facilities and Operations

Licensed Financial Institutions in Tonga

<u>Financial Institutions</u>	<u>Headquarters</u>	
Westpac Bank of Tonga	Nuku'alofa,	Tonga
MBF Bank Limited	Nuku'alofa,	Tonga
Australia and New Zealand Banking Group Limited	Melbourne,	Australia
Tonga Development Bank	Nuku'alofa,	Tonga

The Westpac Bank of Tonga (WBOT) maintained its head office and two branches on Tongatapu as well as branches on the islands of Vava'u, Ha'apai, and 'Eua. The operation of WBOT from its head office in Nuku'alofa was affected by the closure of part of Nuku'alofa at the wake of the civil unrest of November 2006. The MBF Bank Limited maintained its head office on Tongatapu and a branch on the island of Vava'u. The MBF Bank's head office in Nuku'alofa was severely damaged during the riots of November 2006 which caused the operation of MBF Bank Ltd in Tongatapu to be suspended for a few days. Prior to 16 November 2006, the ANZ Bank operated its main branch in Nuku'alofa Tongatapu and also maintained a sub-branch on Vava'u. The main branch of ANZ Bank in Nuku'alofa was completely destroyed during the riots on Thursday 16 November 2006. However, ANZ Bank worked remarkably hard to set up operation at Ma'ufanga, Nuku'alofa and was able to provide basic banking services in the afternoon of Monday 20th November 2006. In December 2006, ANZ Bank opened its Administration office in the Mailetaha Plaza Building in Nuku'alofa and on 26th March 2007, its second branch was opened in the Nuku'alofa CBD. This was a commendable achievement by the ANZ Bank and was crucial for maintaining confidence in the banking system. The TDB maintained its head office on Tongatapu, as well as branches on the islands of Vava'u, Ha'apai, 'Eua, Niuatoputapu and Niuafo'ou. TDB's banking services was also affected by the riots of November 2006 due to the closure of the

Table 4. FINANCIAL SECTOR ACCOUNTS

	2002/03	2003/04	2004/05	2005/06	2006/07
Demand Deposits					
Number of Accounts	17,751	14,487	22,077	2,878	2,657
Value of Deposits (\$m)	57.4	69.7	68.3	56.1	66.7
Saving Deposits					
Number of Accounts	53,790	29,693	66,885	39,361	45,816
Value of Deposits (\$m)	36.9	37.1	41.9	62.4	54.1
Time Deposits					
Number of Accounts	5,546	2,002	2,428	2,318	1,710
Value of Deposits (\$m)	49.3	67.2	88.4	113.0	130.5
Total Number of Accounts	77,087	46,182	91,390	44,557	50,183
Total Value of Deposits (\$m)	143.5	174.0	198.6	231.4	251.2
Source: National Reserve Bank of Tonga					

Nuku'alofa area which included its head office in Nuku'alofa. TDB swiftly set up shop at Queen Salote College to serve its customers' banking requirements.

The total assets of the financial sector (licensed financial institutions) reached \$396.6 million in 2006/07, an increase of \$35.3 million (9.8 percent) over the year. Total net loans by the banks to the non-financial sector grew by \$16.6 million (6.0 percent) compared with a \$49 million (21.8 percent) growth recorded in 2005/06. At the end of the 2006/07, the banks' outstanding loans portfolio comprised: 53.1 percent for private individuals (of which 37.9 percent was for housing); 45.5 percent for industries and businesses including agriculture; and the remaining 1.4 percent was for other types of loans. The marked slowdown in the growth in credit extended by banks to the private sector resulted in improved liquidity position in the banking industry. This slowdown in lending was not only attributed to the Reserve Bank's credit ceiling on the banks' private sector lending but also due to lack of bankable projects. Growth in total net loans slowed to 9.8 percent at the end of October 2006 before it fell to a low of 3.1 percent in February 2007. Following the easing of the Reserve Bank's monetary policy stance in February and April 2007 to allow banks to lend for the recovery of those customers that were affected by the civil disorder in November 2006, total net loans growth picked up to 6.0 percent at the end of June 2007. The remaining balance of banks' assets were invested in other domestic banks including the Reserve Bank.

On the liabilities side, total deposits by non-financial sector grew by \$19.8 million (8.6 percent) to \$251.2 million in 2006/07 and the total number of accounts increased by 12.6 percent to 50,183 (Table 4). Total notes and bonds issued by the banks increased by \$5.5 million (27.1 percent) over the year. The increase in deposits and investment in notes issued by the domestic banks supported the liquidity position of the banking industry during the year. Total borrowing by the banks from other financial institutions increased by \$6.3 million (22.0 percent) mainly sourced from domestic banks.

Financial Performance

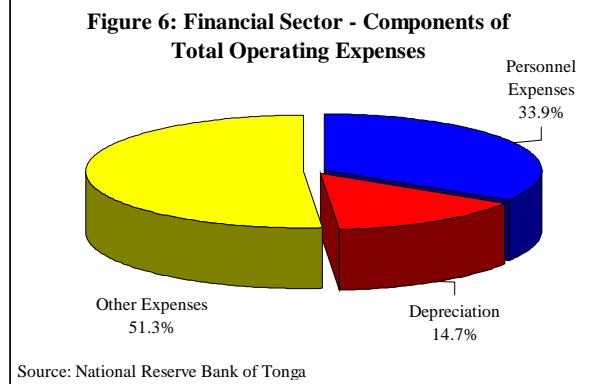
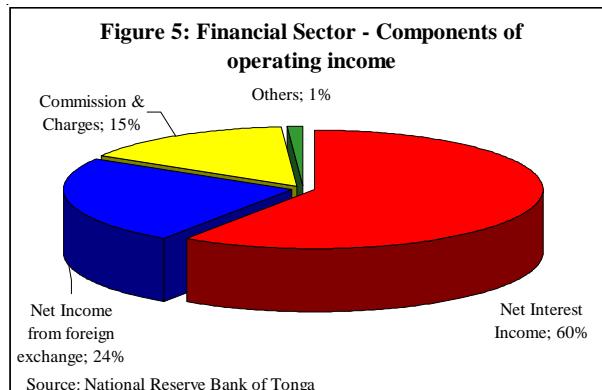
Despite the large provisions made by the banks for losses from the civil disorder of 16 November 2006, the total financial sector as a group showed a pre-tax profit of 4.9 percent in 2006/07, compared with 5.3 percent in 2005/06. This was due to an increase in the banks' average assets while profitability remained relatively unchanged over the year (Table 5).

Total operating income was 11.2 percent of average assets, a slight decline from 11.5 percent in 2005/06. Net interest income was 6.6 percent of average assets, a slight decline from 6.9 percent in 2005/06.

Table 5. FINANCIAL PERFORMANCE

	2002/03	2003/04	2004/05	2005/06	2006/07
Pre-tax Net Profit (% average total assets)	5.5	5.2	6.1	5.3	4.9
Total Operating Income (% average total assets)	11.5	12.0	12.6	11.5	11.2
Net Interest Income (% average total assets)	7.4	7.4	7.7	6.9	6.6
Non-interest Income (% average total assets)	4.1	4.6	4.9	4.7	4.6
Average Net Interest Margin (%)	8.9	8.9	9.8	8.3	7.9
Total Operating Expenses (% average total assets)	5.0	5.6	5.7	4.9	5.5
Consolidated Risk-weighted Capital Ratio (%)	21.8	27.6	22.4	21.2	19.7
Source: National Reserve Bank of Tonga					

Even-though the bulk of banks' operating income was derived from the extension of loans, the composition of net interest income slightly fell to 59.3 percent of total operating income in 2006/07 compared with 59.5 percent in 2005/06. Foreign exchange business made up 24.4 percent of total operating income, an increase from 23.4 percent in the previous year and the balance of 16.3 percent came from commission and charges plus other income sources. Total non-interest income, as a percentage of average assets slightly fell to 4.6 percent from 4.7 percent in the previous year. The average net interest margin (net interest income as a percentage of average earning assets) for the banks decreased to 7.9 percent in 2006/07 compared with 8.3 percent in 2005/06 which was due mainly to the higher growth in average earning assets during the year in particular investments with domestic banks and loans to the non-financial sector.



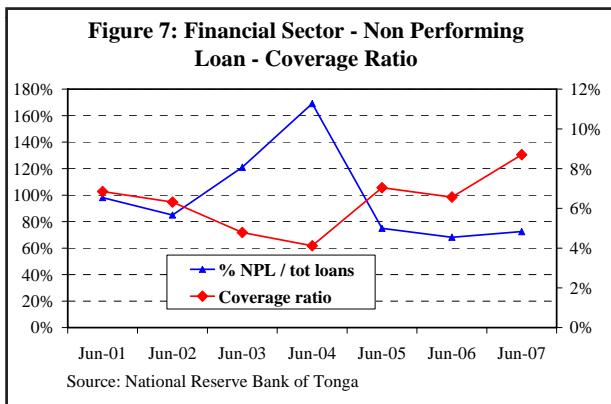
The operating expenses of the banks increased to 5.5 percent of average assets in 2006/07 compared to 4.9 percent in 2005/06. This was due mainly to an increase in the banks' operating expenses over the year attributed to losses incurred by the banks from damages to their properties and loan losses following the civil unrest on 16 November 2006. About 33.9 percent of administrative expenses of the banks were taken up by employees' remuneration, a decrease from 38.1 percent in the previous year. Depreciation and amortisation accounted for 14.7 percent of total administrative expenses and the balance of 51.3 percent was made up of the purchase of various goods and services necessary for the operations of the banks.

Liquidity

Liquidity in the banking system had improved in 2006/07 underpinned by the slow down in credit growth and the improvement in the balance of payment. Net loans as a proportion of deposits decreased to 93.6 percent from 98.2 percent in 2005/06. Furthermore, the Liquid Asset Ratio slightly rose to 10.6 percent compared with 10.3 percent in 2005/06.

Capital

Even-though the consolidated risk weighted capital ratio for all the banks decreased slightly to 20.7 percent at the end of 2007 compared with 21.9 percent at the end of June 2006, the capital position of the banking industry remains strong and above the minimum ratio required by the Reserve Bank. The decline in the capital adequacy ratio over the year was attributed mainly to the growth in risk-weighted assets, in particular loans to the private sector, outweighing the relatively unchanged profitability in the banking system during the year.



performing loans by total loan loss reserves markedly improved to 115.3 percent at the end of June 2007 from 98.5 percent at the end of June 2006 (Figure 7).

Asset Quality

The overall quality of the banks' assets weakened over the year as more of the banks' loans were downgraded to non-accrual status following the civil unrest on 16 November 2006. Total non-performing loans slightly rose to 4.8 percent of total loans compared with 4.5 percent at the end of June 2006. At the same time, the banks increased provisions significantly over the year to take into account the effects of 16 November, therefore the coverage ratio of the non-

Supervision of Licensed Financial Institutions

The Financial Institutions Department continued its supervisory role by monitoring and evaluating the overall strategies, policies and performance of licensed financial institutions. The soundness of the risk management systems of financial institutions and the competence of those managing them are assessed against legal and prudential criteria and minimum standards required by the Reserve Bank. The Reserve Bank continued to undertake its supervisory function through offsite and onsite surveillance. Reports from licensed financial institutions were analyzed to ensure that their activities complied with the terms and conditions of their licences and other specified regulatory and prudential standards such as capital adequacy, limits on credit exposures, asset quality, credit risk grading and provisioning. The reports were also analyzed for any significant changes in their financial conditions.

The Prudential Statement on Administrative Penalties issued for comments in February 2006 became effective in October 2006. This Statement outlines the Reserve Bank's administrative fee structure imposed on licensed financial institutions as stipulated under the Financial Institutions Act 2004. Draft Prudential Statements on Liquidity and Disclosure of Interest Rates and Fees and Charges were issued to the banks for comments during the year. The Prudential Statement on Disclosure of Interest Rates and Fees and Charges became effective in August 2007. This Statement sets out the Reserve Bank's requirements with regard to the form and content of the disclosure of interest rates and fees and charges relating to the products and services offered by licensed financial institutions in Tonga. This will enable the general public to compare interest rates and fees and charges between various services and products provided by banks. Moreover, this should foster market discipline and competition.

The Reserve Bank conducted an on-site examination of one licensed financial institution to review its risk management systems and their applications. The main focus of the risk management review was on credit, operational, liquidity, and interest rate risk management systems as well as compliance with anti-money laundering and combating the financing of terrorism laws. The Reserve Bank continued to hold regular meetings with licensed financial institutions in order to discuss their operations and compliance with the financial institutions regulations. In addition, the Reserve Bank continued to conduct quarterly technical meetings with each bank to clarify the Reserve Bank's reporting requirements, improve the accuracy of reporting to the Reserve Bank and to discuss issues of mutual interest to both parties. The Reserve Bank also held technical meetings with the Ministry of Labour, Commerce, and Industries to

coordinate efforts and to facilitate the procedures for licensing of banks and foreign exchange dealers.

The damage caused by the civil disorder in November 2006 threatened the stability and confidence in the financial system of the Kingdom. However, the Reserve Bank worked closely together with the banks, the government and the public to ensure that confidence in the domestic financial system was maintained. This was deemed successful in that there were no signs of capital flight and or abnormal increase in public demand for cash.

To assist businesses that were affected by the civil unrest of November 2006, a business recovery facility funded by the Australian and New Zealand Governments were established and the Reserve Bank is the custodian for this facility.

The Association of Banks in Tonga was established in April 2007 which was welcomed by the Reserve Bank as it will encourage coordination and cooperation among domestic banks which would support the soundness and stability of the financial system. It will ensure a level playing field and enhance the effectiveness and efficiency of the Reserve Bank in that all issues for the banking system would be dealt with through this Association.

Transaction Reporting Authority

The Financial Institutions department is also responsible for carrying out the functions of the Transaction Reporting Authority (TRA) as stipulated under section 11(2) of the Money Laundering and Proceeds of Crime Act 2000. The functions of the TRA are similar to the functions of Financial Intelligence Units (FIU) in other countries.

During the year, the Reserve Bank continued with its effort to develop its suspicious transaction reporting framework in cooperation with licensed financial institutions and licensed foreign exchange dealers. The commercial banks and authorized restricted foreign exchange dealers reported a total of 19 suspicious transactions to the TRA during the year, a marked increase compared with 5 reports in the previous year. The increase in the number of suspicious transaction reported so far reflects an improvement in the licensed financial institutions' and licensed foreign exchange dealers' awareness regarding money laundering and terrorist financing. The Anti-Money Laundering Guidelines issued for comments in the previous year became effective in October 2006.

Following the 2006 annual meeting of the Asia Pacific Group on Money Laundering (APG), the Pacific Anti-Money Laundering Program (PALP) was established, funded by the U.S. Government and other donors. This program involves providing mentors in the areas of law enforcement, legal and FIU. The Legal Mentor, based in Tonga at the Crown Law Office, conducted a preliminary review of Tonga's Anti-Money Laundering/Counter Terrorist Financing (AML/CFT) legal framework and will assist in drafting legislative amendments where necessary.

The PALP Legal Mentor is working together with the members of the Committee on Money Laundering and Terrorist Financing established by Cabinet in 2003 of which the TRA is a member, towards Tonga's preparation for its mutual evaluation by the APG in 2009.

In March 2007, through Tonga's membership in the APG, a review of the Transaction Reporting Authority was conducted by an expert funded by the PALP. The TRA has begun to implement recommendations from this review.

Operations of the Reserve Bank

Currency Operations

Circulation Notes

At the 30th June 2007, the face value of currency notes on issue, both new and reissuable, totaled \$20.6 million. This was an increase of 5 percent over the previous year of \$19.6 million. Currency notes issued during the year totaled \$44 million and currency deposited totaled \$42 million of which \$4.6 million were classified by the Reserve Bank as unfit for reissue and were destroyed; the balance was retained for reissue. In order for the Bank to maintain an adequate supply of currency notes to meet public demand, the Bank ordered and received new stock of \$50 currency notes during the year. The currency notes of the Kingdom are printed by De La Rue in the United Kingdom.

Circulation Coins

At the end of June 2007 the face value of coins on issue totaled \$1.7 million, an increase of 6 percent from \$1.6 million the previous year. During the year, coins to a face value of \$94,768 were issued, \$34,200 of which were new coins. During the year the Bank did not order new coins.

Note Trust Depots

The Reserve Bank has Note Trust Depot (NTD) service arrangement with all commercial banks. The record shows that commercial banks reduced their utilization of NTDs this year. During 2006/07 the commercial banks lodged a total of \$11.5 million (\$18.5 million in 2005/06) and withdrew \$12 million (\$19.1 million in 2005/06). Lodgements to and withdrawals from NTDs decreased by 38 and 37 percent respectively over the previous year while deposits to the NRBT vault decreased by 2 percent. The Bank conducted surprise checks of these NTDs during the year and all were in order.

Currency Operations after the civil disorder of 16 November

To ensure the smooth and safe continuation of currency issue operations to the public by the two banks that were affected by the civil unrest of 16 November, the Reserve Bank increased its banking days to five instead of the normal two days per week. The Reserve Bank also waived all penalties relating to non-banking days withdrawals and deposits of currency notes and coins by banks. This was to ensure that the two banks kept only working stocks on their premises and were able to deposit surplus funds and withdraw as and when required from the Reserve Bank. This service to banks continued until the two banks were able to have their strong rooms restored and certified as secure by Chubb Security Agent, South Pacific Safe and Security Limited of New Zealand.

Counterfeits

During the year 3 counterfeit notes were reported to the Reserve Bank compared to 7 cases in the previous year. One \$5 note, one \$20 note and one \$50 note. These counterfeit notes were reported by a member of the public and Westpac Bank of Tonga, Nuku'alofa branch in January and April, 2007. The Reserve Bank sent these counterfeit notes to De La Rue for testing and verification. Examination of these notes by De La Rue confirmed that they were indeed counterfeit. The Reserve Bank has produced and issued to the public brochures on identifying counterfeit notes both in English and Tongan. The public has also been advised to report to both the Reserve Bank and the Police if they receive any suspicious looking currency notes.

Numismatic Coins

During the year numismatic coins were issued to collectors throughout the world under agreements between the Reserve Bank and various producers for the production and marketing of coins of various denominations. Total revenue collected from numismatic coins program during the year was \$81,804 and this amount has been included with other income of the Reserve Bank in its Income Statement.

Financial Performance

Gross income from operations for the year ended 30 June 2007 amounted to \$7.434 million (2006, \$6.236 million). The improvement in the Reserve Bank's gross income in 2006/07 was mainly due to the higher than expected level of investible reserves and yield throughout the year. Interest expense, currency, administration and other costs totaled \$3.820 million (2006, \$3.079 million). The net operating profit for the year increased by 14.5 percent to \$3.614 million (2006, \$3.156 million).

The Minister of Finance has approved that the net profit of \$3.614 million for the year ended June 2007 be transferred to the Reserve Bank's General Reserve account increasing it to \$10.8 million. This would further strengthen the capital position of the Reserve Bank.

Information Systems and Technology

In order to enhance the security and efficiency of the Reserve Bank's international payments transactions, the Reserve Bank outsourced a major part of the information and technology management system for its international payments system to Decillion Solutions in Sydney, Australia. This company is the authorized Swift Partner who serves Swift Clients in the Asia Pacific Region.

The Reserve Bank continued to improve its data management systems by securing an offsite location for storage of the Reserve Bank's electronic information as back up. It commenced implementation of an in-house database management system to improve efficiency and effectiveness of the work of the international financial markets unit. The documentation of the Bank's IT policies in the areas of Networking and Emailing was successfully completed to assist with the operations of the Department.

General Administration

In addition to the normal services of administration to the Reserve Bank, one of the major achievements during the year was the implementation, monitoring and continued awareness training of staff on the new performance-based appraisal system. The Administration department was a major player in the successful compilation of two major documents of the Bank, a master departmental operations procedures and, a master staff job descriptions.

Staff

Staff numbers were maintained at 65 at the end of June 2007 as new recruitments matched those that left the services of the Bank during the year. Mr. Brett Winton from the Reserve Bank of Australia had completed his 2 years contract as Manager of Research Department in March, 2007. He was replaced by Mr. Richard Sullivan from the Reserve Bank of New Zealand, who is funded by the Commonwealth Fund for Technical Co-operation (CFTC). Miss Jessie Cocker, Manager of Financial Institutions and Markets was nominated to take up one year Tonga's turn to provide an Advisor in the Office of the Executive Director of the South East Asia Group, International Monetary Fund, Washington D.C., United States of America. Ms Cocker's appointment commenced 1 May 2007.

During the year, the Reserve Bank continued to receive advisory and technical services provided by the International Monetary Fund, AusAID, NZAid, the Pacific Financial Technical Assistance Centre (PFTAC) based in Suva, Reserve Bank of Fiji, Reserve Bank of New Zealand and Reserve Bank of Australia. These advisory and technical services were mainly in the areas of liquidity management, banking supervision and onsite visits to banks. Other assistance was received from private service providers in the areas of information systems and technology and building management.

Training

Staff training needs analysis (TNA) is part of the Reserve Bank's new performance based appraisal system. TNA was conducted for each member of the staff and was then used as the guide by the Reserve Bank during the year to provide local and overseas training opportunities for its staff to facilitate capacity building. The overseas training courses attended by staff included the IMF/STI courses in Singapore on Payment Systems – Sound and Efficient National Payment and Settlement Infrastructure, Bank of International Settlement workshop on Advanced Reserve Management, Commonwealth Secretariat seminar on Foreign Remittances and Development in the Pacific Region.

The Bank arranged for 2 senior staff to attend short training attachments at the Reserve Bank of Fiji with the Governor's Office and the Settlement Department. One of the staff members continues with her post graduate studies under the AusAID scholarship program in Australia.

Local training for staff included the United Nations Office on Drugs and Crime (UNODC) Anti-Money Laundering Training conducted at the Ministry of Police and Customer Service Training by S&K Performance Solution conducted at the Reserve Bank. Apart from on-the-job training, the Reserve Bank provided specific in-house training to the staff on banking supervision and microsoft applications. The Reserve Bank continued to support staff development through financial assistance to those undertaking approved part time and correspondence courses aligned to the Training Policy of the Bank.

Attendance at Meetings

In July 2006, the Assistant Manager Financial Institutions attended the APG annual meeting held at Manila, Philippines. In September 2006, the Governor and the Manager of Research were part of the government's delegation to the annual meeting of the World Bank/IMF held in Singapore. In December 2006, the Governor attended the South Pacific Central Bank Governors' annual meeting held in Wellington, New Zealand. In March 2007, the Deputy Governor and the Assistant Manager Financial Institutions attended the Central Banking Course for the Pacific Islands held in Apia, Samoa. In May 2007, the Governor and Assistant Manager of Administration and Information Technology attended the Asian Development Bank (ADB) annual meeting held in Kyoto, Japan as part of the Government's delegation. The Governor attended a high level and bilateral meeting on the World Bank Remittances Project held in Sydney, Australia, in June 2007.

Security

The Reserve Bank's security unit continued to carry out its responsibilities of ensuring that the security and safety of the Bank's staff and premises were maintained at all times. It strengthened its security measures during and after the civil unrest of November 2006 to ensure maximum security of the Bank's assets and tenants.

Building, Plant and Equipment

The Reserve Bank's building, plant and equipment unit continued to maintain the Bank's building, plant and equipment at a high standard. The major project implemented this year was the upgrade of Level 5 of the Reserve Bank building. This is to prepare for the South Pacific Governors' annual meeting to be hosted by the National Reserve Bank of Tonga for the first time in December 2007.

External Relations

During the year, the Reserve Bank continued to submit reports for the government on the level of the foreign reserves, interest rates and exchange rates. The Reserve Bank conducted regular meetings with the government and the domestic banks in order to discuss and review activities in the economy and the financial system as well as to discuss Reserve Bank policy issues. The Reserve Bank also met with representatives of international aid agencies and bilateral aid donors to discuss matters of mutual interest. In April 2007, the Reserve Bank again hosted the IMF Article IV annual consultation.

Board of Directors

During the year, the Board of Directors met regularly to formulate the policies of the Reserve Bank and to monitor its operations. There were no changes to the members of the Board during the year.

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Senior Officers

Senior Officers as at 30 June 2007

Governor Siosi Cocker Mafi

Deputy Governor Inia R. Naiyaga

Manager, Research Department Richard Sullivan

**Manager Information System
& Technology and Administration** Elizabeth Baker

Manager, Accounts & Currency Lata Tangimana

Acting Manager, Financial Institutions & Markets ‘Ungatea Latu

Assistant Manager, Research Department ‘Anapuli Matoto

Guard Commander Semisi Fifita

Senior Building Officer Poasi Fonua

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National Reserve Bank of Tonga

Financial Statements Year Ended 30 June 2007

Index

24	Directors' Report
27	Statement by Directors
28	Independent Audit Report
30	Income Statement
31	Balance Sheet
32	Statement of Changes in Equity
33	Statement of Cash Flows
34	Notes to and Forming Part of the Accounts

NATIONAL RESERVE BANK OF TONGA**FINANCIAL STATEMENTS
30 JUNE 2007****DIRECTORS' REPORT**

In accordance with a resolution of the Board of Directors, the directors herewith submit the Balance Sheet of the Bank as at 30 June 2007, and the related Income Statement, Statement of Changes In Equity, and Cash Flow Statement for the year ended on that date and report as follows:

1. DIRECTORS

The following were directors of the Bank at any time during the financial year and up to the date of this report:

HRH Princess Salote Pilolevu Tuita
Hon STT 'Utoikamanu
Mr Richard Prema
Mrs Siosi C Mafi

2. PRINCIPAL ACTIVITIES

The National Reserve Bank of Tonga's principal purposes as a central bank, as defined in Section 4 of the NRBT Act 1988, shall be:

- (a) to regulate the issue of currency, and the supply, availability and international exchange of money;
- (b) to manage the external reserves of the Kingdom;
- (c) to promote monetary stability;
- (d) to promote a sound financial structure;
- (e) to foster credit and exchange conditions conducive to the orderly and balanced economic development of the Kingdom;
- (f) to provide advisory services to the Minister on banking and monetary matters;
- (g) to be the principal banker and fiscal agent of the Government;
- (h) to undertake banking business, in Tonga or elsewhere subject to the provisions of this Act and
- (i) to undertake the licensing and supervision of financial institutions.

3. TRADING RESULTS

The operating profit of the Bank for the year ended 30 June 2007 was \$3,613,967 (2006: \$3,156,192).

4. RESERVES

In accordance with Section 8(1)(a) of the National Reserve Bank of Tonga Act, the Minister and the Board of Directors have agreed to transfer \$3,613,967 (2006: \$3,156,192) to the General Reserve at year end.

NATIONAL RESERVE BANK OF TONGA**FINANCIAL STATEMENTS
30 JUNE 2007****5. PAYABLE TO GOVERNMENT**

In accordance with Section 33 (3) of NRBT Act, 1988, one fifth of remaining credit balance of the Revaluation Reserve is payable to the Government of Tonga. The amount payable for the year ended 30 June 2007 is \$1,231,078 (2006: \$336,918).

6. BAD AND DOUBTFUL DEBTS

The directors took reasonable steps before the Bank's financial statements were made out to ascertain that all known bad debts were written off and adequate provision was made for doubtful debts.

At the date of this report, the directors are not aware of any circumstances which would render the amount written off for bad debts, or the amount of the provision for doubtful debts, inadequate to any substantial extent.

7. PROVISIONS

There were no material movements in provisions during the year apart from the normal amounts set aside for such items as doubtful debts, depreciation and employee entitlements.

8. ASSETS

The directors took reasonable steps before the Bank's financial statements were made out to ascertain that the assets of the Bank were shown in the accounting records at a value equal to or below the value that would be expected to be realised in the ordinary course of business.

At the date of this report, the directors are not aware of any circumstances which would render the values attributable to the assets in the financial statements misleading.

9. DIRECTORS BENEFIT

No director of the Bank has, since the end of the previous financial year, received or become entitled to receive a benefit by reason of contract made by the Bank with the director or with a firm of which the director is a member, or with a company in which the director has substantial financial interest.

10. EVENTS SUBSEQUENT TO BALANCE DATE

Since the end of the financial year the directors are not aware of any matter or circumstances not otherwise dealt with in the report that has significantly affected the operations of the Bank, the results of those operations or the state of affairs of the Bank in subsequent financial years.

11. BASIS OF ACCOUNTING

The directors believe the basis of the preparation of financial statements is appropriate and the Bank will be able to continue in operation for at least 12 months from the date of this statement. Accordingly the directors believe the classification and carrying amounts of assets and liabilities as stated in these financial statements to be appropriate.

NATIONAL RESERVE BANK OF TONGA**FINANCIAL STATEMENTS**
30 JUNE 2007**12. OTHER CIRCUMSTANCES**

At the date of this report, the directors are not aware of any circumstances not otherwise dealt with in this report or financial statements which render any amounts stated in the financial statements misleading.

13. UNUSUAL TRANSACTIONS

The results of the Bank's operations during the financial year have not in the opinion of the directors been substantially affected by any item, transaction or event of a material and unusual nature other than those disclosed in the financial statements.

For and on behalf of the Board of Directors in accordance with a resolution of the Directors this 27th day of September, 2007.



HRH Princess Salote Pilolevu Tuita
ACTING CHAIRPERSON



Mrs Siosi C Mafi
GOVERNOR

STATEMENT BY DIRECTORS

In the opinion of the Directors:

- (a) the accompanying income statement is drawn up so as to give a true and fair view of the results of the Bank for the year ended 30 June 2007,
- (b) the accompanying balance sheet is drawn up so as to give a true and fair view of the state of affairs of the Bank as at 30 June 2007,
- (c) the accompanying statement of changes in equity is drawn up so as to give a true and fair view of the movement in equity for the year ended 30 June 2007, and
- (d) the accompanying cash flow statement is drawn up so as to give a true and fair view of the cash flows of the Bank for the year ended 30 June 2007.

For and on behalf of the Board of Directors by authority of a resolution of the Directors
this 27th day of September, 2007.



**HRH Princess Salote Pilolevu Tuita
ACTING CHAIRPERSON**



**Mrs Siosi C Mafi
GOVERNOR**

NATIONAL RESERVE BANK OF TONGA**FINANCIAL STATEMENTS
30 JUNE 2007****INDEPENDENT AUDIT REPORT**

To the shareholder of the National Reserve Bank of Tonga.

Scope

We have audited the accounts of the National Reserve Bank of Tonga for the year ended 30 June 2007 as set out on pages 30 to 46. The Bank's directors are responsible for the preparation and presentation of the accounts and the information they contain. We have conducted an independent audit of these accounts in order to express an opinion on them to the Board of Directors of the Bank.

Our audit has been conducted, in accordance with International Standards of Auditing, to provide reasonable assurance as to whether the accounts are free of material misstatement. Our procedures included examination on a test basis, of evidence supporting the amounts and other disclosures in the accounts and the evaluation of accounting policies and significant accounting estimates. These procedures have been undertaken to form an opinion as to whether in all material respects, the accounts are presented fairly in accordance with the provisions of the National Reserve Bank of Tonga Act, 1988 so as to present a view which is consistent with our understanding of the Bank's financial position and the results of its operations.

The audit opinion expressed in this report has been formed on the above basis.

Audit Opinion

In our opinion

- a) proper books of account have been kept by the Bank, so far as it appears from our examination of those books, and
- b) the accompanying accounts:
 - (i) are in agreement with the books of account;
 - (ii) to the best of our information and according to the explanations given to us:
 - (a) give a true and fair view of the state of affairs of the Bank as at 30 June 2007 and of the results of the Bank for the year ended on that date;

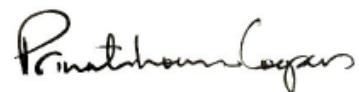
NATIONAL RESERVE BANK OF TONGA

**FINANCIAL STATEMENTS
30 JUNE 2007**

INDEPENDENT AUDIT REPORT

(b) are in accordance with the provisions of the National Reserve Bank of Tonga Act, 1988.

We have obtained all the information and explanations, which, to the best of our knowledge and belief, were necessary for the purposes of our audit.



Lautoka, Fiji
27 September 2007

PricewaterhouseCoopers
Chartered Accountants

NATIONAL RESERVE BANK OF TONGA**INCOME STATEMENT
YEAR ENDED 30 JUNE 2007**

Income	Notes	2007	2006
		\$	\$
Interest Income	3	6,346,102	5,264,892
Other Income	4	1,087,773	970,900
Total Operating Income		7,433,875	6,235,792
Expenses			
Interest expense	5	998,766	626,548
Administration and other expenses	6	2,821,142	2,453,052
Total Operating Expenses		3,819,908	3,079,600
Operating Profit		\$3,613,967	\$3,156,192
TRANSFER TO GENERAL RESERVES		(3,613,967)	(3,156,192)
BALANCE PAYABLE TO GOVERNMENT OF TONGA		\$ Nil	\$ Nil

The above income statement should be read in conjunction with the accompanying notes.

NATIONAL RESERVE BANK OF TONGA**BALANCESHEET
AS AT 30 JUNE 2007**

	Notes	2007	2006
		\$	\$
ASSETS			
Foreign Currency Assets			
Short Term Investments and Current Accounts	7	85,463,858	77,118,839
Accrued Interest		894,348	1,586,134
International Monetary Fund	8		
- Reserve Tranche Position		5,043,114	5,174,223
- Special Drawing Rights		1,108,574	934,208
- Currency Subscription		15,620,686	15,324,531
Local Currency Assets			
Cash on Hand		20,341	71,756
Accrued Interest		341,663	315,368
Domestic Securities	9	16,008,832	16,241,832
Other Assets	10	2,038,103	1,959,725
Property, Plant and Equipment	11	6,877,571	6,698,168
Total Assets		133,417,090	125,424,784
LIABILITIES			
Foreign Currency Liabilities			
Demand Deposits	12(a)	4,746,572	7,142,915
Accrued Interest		31,217	22,535
Local Currency Liabilities			
Demand Deposits	12(b)	45,170,176	40,031,839
NRBT Notes	13	-	1,494,668
Accrued Interest		417,498	729,546
Currency in Circulation	14	22,222,498	21,173,164
Statutory Reserve Deposits	15	25,544,000	28,185,000
International Monetary Fund - Currency Subscription	8	15,602,024	15,304,601
Other Liabilities	16	1,954,665	802,687
Total Liabilities		115,688,650	114,886,955
NET ASSETS		\$17,728,440	\$10,537,829
CAPITAL AND RESERVES			
Authorised Capital		2,000,000	2,000,000
Paid up Capital		2,000,000	2,000,000
General Reserves		10,804,123	7,190,156
Revaluation Reserve Account		4,924,317	1,347,673
TOTAL CAPITAL AND RESERVES		\$17,728,440	\$10,537,829

The above balance sheet should be read in conjunction with the accompanying notes.

NATIONAL RESERVE BANK OF TONGA**STATEMENTS OF CHANGES IN EQUITY**
YEAR ENDED 30 JUNE 2007

			Revaluation		
	Paid up Capital	General Reserves	Reserve Account	Total	
	\$	\$	\$	\$	
Balance - 30 June 2005	2,000,000	4,033,964	1,046,240	7,080,204	
Net(losses) arising during the year from translation of foreign currencies to Tongan currency	-	-	638,351	638,351	
Transfer out of general reserves as provided for under Section 6(2) of the NRBT Act, 1988 and approved by the Privy Council	-	-	-	-	
One fifth of remaining credit balance payable to the Government of Tonga in accordance with Section 33 (3) of NRBT Act, 1988	-	-	(336,918)	(336,918)	
Transfer from Income Statement (as provided for under Section 8(1) (a) of the NRBT Act, 1988, and approved by the Minister of Finance	-	3,156,192	-	3,156,192	
Increase in Paid up Capital as provided for under Section 6(2) of the NRBT Act, 1988 and approved by the Privy Council	-	-	-	-	
Balance 30 June 2006	2,000,000	7,190,156	1,347,673	10,537,829	
Net gain arising during the year from translation of foreign currencies to Tongan currency	-	-	4,807,722	4,807,722	
One fifth of remaining credit balance payable to the Government of Tonga in accordance with Section 33 (3) of NRBT Act, 1988	-	-	(1,231,078)	(1,231,078)	
Transfer from Income Statement (as provided for under Section 8(1) (a) of the NRBT Act, 1988, and approved by the Minister of Finance	-	3,613,967	-	3,613,967	
Balance 30 June 2007	\$2,000,000	\$10,804,123	\$4,924,317	\$17,728,440	

The above statement of changes in equity should be read in conjunction with the accompanying notes.

NATIONAL RESERVE BANK OF TONGA**STATEMENTS OF CASH FLOWS**
YEAR ENDED 30 JUNE 2007

	Note	2007	2006
		\$	\$
CASH FLOWS FROM OPERATING ACTIVITIES			
Rental income		254,769	297,852
Numismatic sales		81,804	56,788
Other income		711,430	630,368
Interest received		7,011,593	4,790,981
Purchase of currency		(423,105)	(790,213)
Interest paid		(1,302,132)	(71,579)
Administration and other expenses		(2,086,357)	(1,779,238)
Net cash inflow from operating activities		4,248,002	3,134,959
CASH FLOWS FROM INVESTING ACTIVITIES			
Purchase of fixed assets		(582,216)	(265,100)
Proceeds from sale of fixed assets		-	-
Net movement in IMF accounts		(41,989)	(541,685)
Net movement in staff loans		(52,181)	75,263
Net movement in Government of Tonga bonds		233,000	(6,718,000)
Net cash (outflow)/inflow from investing activities		(443,386)	(7,449,522)
CASH FLOWS FROM FINANCING ACTIVITIES			
Net movement in currency in circulation		1,074,941	2,729,567
Net movement in demand deposits		6,151,533	8,896,038
Net movement in statutory deposits		(2,641,000)	(1,902,000)
Net movement in NRBT notes		(1,494,668)	1,494,668
Net movement in Government of Tonga accounts		(3,409,540)	(6,937,217)
Net cash inflow/(outflow) from financing activities		(318,734)	4,281,056
NET EFFECT OF CHANGE IN EXCHANGE RATE		4,807,722	638,351
NET INCREASE/(DECREASE) IN CASH CASH AT BEGINNING OF FINANCIAL YEAR		8,293,604	604,844
CASH AT END OF FINANCIAL YEAR	17	<u>\$85,484,199</u>	<u>\$77,190,595</u>

The above cash flow statement is to be read in conjunction with the accompanying notes.

NATIONAL RESERVE BANK OF TONGA**NOTES TO AND FORMING PART OF
THE FINANCIAL STATEMENTS
YEAR ENDED 30 JUNE 2007****1. GENERAL INFORMATION**

The National Reserve Bank of Tonga's principal purposes as a central bank, as defined in Section 4 of the NRBT Act 1988, shall be:

- (a) to regulate the issue of currency, and the supply, availability and international exchange of money;
- (b) to manage the external reserves of the Kingdom;
- (c) to promote monetary stability;
- (d) to promote a sound financial structure;
- (e) to foster credit and exchange conditions conducive to the orderly and balanced economic development of the Kingdom;
- (f) to provide advisory services to the Minister on banking and monetary matters;
- (g) to be the principal banker and fiscal agent of the Government;
- (h) to undertake banking business, in Tonga or elsewhere subject to the provisions of this Act and
- (i) to undertake the licensing and supervision of financial institutions.

These financial statements have been approved for issue by the Board of Directors on 27th September 2007.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND STATUTORY REQUIREMENTS

The financial statements of the National Reserve Bank of Tonga have been prepared based on accounting principles approved by the Board of Directors in compliance with the National Reserve Bank of Tonga Act 1988.

The financial statements are prepared on the basis of the historical cost convention, which has no regard to changes in the levels of prices. Unless otherwise stated the accounting policies adopted are consistent with those of the previous year.

a) Foreign currencies

Foreign currencies have been translated to Tongan currency at rates of exchange ruling at year end. Realised and unrealised gains and losses arising during the year from changes in the valuation of foreign currencies are taken to the revaluation reserve account in accordance with the provisions of Section 33 of the National Reserve Bank of Tonga Act, 1988 and are not included in the computation of annual profits and losses of the Bank. Losses arising from such changes are set off against any credit balance in the revaluation reserve account; if such balance is insufficient to cover such losses, His Majesty in Council shall cause to be transferred to the ownership of the Bank non-negotiable non-interest bearing securities issued by the Government to the extent of the deficiency. Any credit balance in the revaluation reserve account at the end of each year is applied first, on behalf of the Government, to the redemption of any non-negotiable non-interest bearing notes previously transferred to the Bank by the Government to cover losses. Thereafter, one fifth of the remaining balance is paid to the Government, except that if the remaining balance does not exceed \$100,000 it shall be paid in full to the Government.

NATIONAL RESERVE BANK OF TONGA**NOTES TO AND FORMING PART OF
THE FINANCIAL STATEMENTS
YEAR ENDED 30 JUNE 2007****2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND STATUTORY REQUIREMENTS – continued****b) Financial Assets and Liabilities***Investment Securities*

The Reserve Bank only invests in securities with the intention to hold to maturity. The Reserve Bank does not invest in securities for trading purposes.

Held-to-maturity investments are carried at amortised cost. Any premium or discount on purchase is capitalised and amortised over the term of the maturity on a constant yield to maturity basis.

All purchases and sale of investment securities are recognised at settlement date, which is the date that the asset is transferred to the Reserve Bank.

Other Financial Assets and Liabilities

Local and foreign cash, deposits and short-term advances are valued at transaction date value.

c) Currency in Circulation

The face value of notes and coins on issue is taken up as a liability in the accounts. Where notes and coins on issue are no longer considered to be in circulation, either through their age or their numismatic value, they are written back to income.

d) Coins sold as numismatic items

The Bank sells, or receives royalties on, coins which are specially minted or packaged as numismatic items. These coins have not been accounted for as currency issued for circulation as they are not issued for monetary purposes. In terms of Section 53(2) of the National Reserve Bank of Tonga Act, 1988, His Majesty in Council has specified by notice in the Gazette that the Bank shall not be required to include in its financial statements the face value of these coins in circulation.

e) Income tax

The Bank is exempted from all Government taxes in accordance with Section 55 of the National Reserve Bank of Tonga Act, 1988.

f) Depreciation

Fixed assets are depreciated on a straight line basis so as to write off the cost of each fixed asset over its estimated useful life. The principal annual rates in use are:

Leasehold buildings	1.01%
Plant and equipment	10.0%
Carpets, drapes and security system	10.0%
Furniture, fittings, computer equipment and motor vehicles	25.0%

NATIONAL RESERVE BANK OF TONGA**NOTES TO AND FORMING PART OF
THE FINANCIAL STATEMENTS
YEAR ENDED 30 JUNE 2007****2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND STATUTORY REQUIREMENTS - Continued****g) Employee Entitlements**

The Bank administers a staff superannuation scheme to which both the Bank and staff make contributions based on the years of service. The liability recognised in the balance sheet in respect of the staff retirement fund is on an accrual basis. Other employee related liabilities are recognised and measured as the amount unpaid at year end, at the current pay rate in respect of employee services up to date.

h) Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents includes notes and coins held by National Reserve Bank of Tonga tellers cash, short term bills and current accounts.

i) Revenue Recognition

Interest income is brought to account on an accrual basis.

j) Staff Loans

Loans are carried in the balance sheet at historical cost net of specific provisions for bad and doubtful loans.

Provisions for bad and doubtful debts are made based on appraisal carried out at the end of the financial year and the amount has been reliably estimated. The amounts of potential losses that have been identified are either written off against provisions in the year in which they are recognized or recognized as an expense in the income statement.

k) Provisions

Provisions are recognised when the Bank has a present legal or constructive obligation as a result of past events; it is more likely than not that an outflow of resources will be required to settle the obligation, and the amount has been reliably estimated.

l) Reserves

Reserves are maintained to cover the broad range of risks to which the Bank is exposed.

The General Reserves provides for events which are contingent and which are non-foreseeable. The transfer to and from the general reserves require the approval of the Minister of Finance under the NRBT Act, 1988.

Unrealised exchange gains and losses arising from revaluation of foreign currencies are transferred to the Revaluation Reserve (refer Note 2(a)).

NATIONAL RESERVE BANK OF TONGA**NOTES TO AND FORMING PART OF
THE FINANCIAL STATEMENTS
YEAR ENDED 30 JUNE 2007****2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND STATUTORY REQUIREMENTS - Continued****m) Segment Reporting**

The Reserve Bank present financial assets and financial liabilities, and their associated income and expense streams, by distinguishing between foreign currency and local currency activities. The Bank considers that these reporting approaches provide appropriate segmental reporting of the Bank's activities.

n) Leases

Where the Reserve Bank is the lessee, the lease rentals payable on operating leases are recognised in the Income Statement over the term of the lease.

Where the Reserve Bank is the lessor, the assets leased out are retained in Property, Plant & Equipment.

o) Currency of Presentation

All amounts are expressed in Tongan Pa'anga.

p) Comparatives

Where necessary, comparative figures have been adjusted to conform with changes in presentation in the current year.

3. INTEREST INCOME

	<u>2007</u>	<u>2006</u>
	\$	\$
Interest on Overseas investments	5,235,098	4,237,969
Interest on Domestic investments	1,089,095	1,007,054
Interest on Staff Loans	21,909	19,869
	<u>\$6,346,102</u>	<u>\$5,264,892</u>

4. OTHER INCOME

	<u>2007</u>	<u>2006</u>
	\$	\$
Numismatic Coins	81,804	82,395
Rental Income	331,237	317,388
Gain on sale of Assets	7,894	833
Forex sales/ purchases	642,737	546,222
Bank user fees	23,591	21,225
Information services - publications	510	2,837
	<u>\$1,087,773</u>	<u>\$970,900</u>

NATIONAL RESERVE BANK OF TONGA**NOTES TO AND FORMING PART OF
THE FINANCIAL STATEMENTS
YEAR ENDED 30 JUNE 2007****5. INTEREST EXPENSE**

	<u>2007</u> \$	<u>2006</u> \$
Interest on Foreign Currency Accounts	72,954	19,302
Interest on Domestic Currency Accounts	925,812	607,246
	<u>\$998,766</u>	<u>\$626,548</u>

6. ADMINISTRATION AND OTHER EXPENSES

	<u>2007</u> \$	<u>2006</u> \$
Administration	954,857	1,011,052
Staff Costs	1,026,178	1,065,551
Audit Fees	18,550	20,915
Currency Issue (refer note 10)	418,743	(79,323)
Depreciation	402,814	434,857
	<u>\$2,821,142</u>	<u>\$2,453,052</u>

7. SHORT TERM INVESTMENTS AND CURRENT ACCOUNTS

	<u>2007</u> \$	<u>2006</u> \$
Current Account	14,722,511	14,769,033
Short term Investments	70,741,347	62,349,806
	<u>\$85,463,858</u>	<u>\$77,118,839</u>

8. INTERNATIONAL MONETARY FUND

- (i) The Bank was designated to serve with effect from 1 July 1989 as the fiscal agent of the Kingdom of Tonga for the purposes of the International Monetary Fund by virtue of Section 51(1) of the National Reserve Bank of Tonga Act, 1988, and assumed the financial obligations of the membership of the Kingdom of Tonga as from that date by virtue of section 36(1)(c) of the National Reserve Bank of Tonga Act, 1988.
- (ii) As at 30 June 2007, Tonga's membership subscription to the International Monetary Fund was SDR6,900,000 (2006: SDR6,900,000). Of the total amount SDR 1,711,633 (2006: SDR1,711,633) had been paid in foreign currencies, shown in the Balance Sheet as Reserve Tranche, and the remaining balance representing the Currency Subscription portion was satisfied by crediting the demand deposit accounts of the International Monetary Fund with the Bank.

NATIONAL RESERVE BANK OF TONGA**NOTES TO AND FORMING PART OF
THE FINANCIAL STATEMENTS
YEAR ENDED 30 JUNE 2007****9. DOMESTIC SECURITIES**

	2007	2006
	\$	\$
Government of Tonga Bonds	<u>\$16,008,832</u>	<u>\$16,241,832</u>

These securities which are valued in accordance with note 2(b) of the financial statements have varying maturity dates up to 31 October 2011. It is the Bank's intention to hold these investments to maturity.

10. OTHER ASSETS

	2007	2006
	\$	\$
Staff loans and advances	464,886	412,706
Currency and numismatics	1,512,621	1,498,150
Other assets	93,534	68,807
	<u>2,071,041</u>	<u>1,979,663</u>
Less: Provision for doubtful debts on staff loans and advance	(32,938)	(19,938)
	<u>\$2,038,103</u>	<u>\$1,959,725</u>

The amount charged to the income statement is now based on the cost of notes and coins issued for circulation.

11. PROPERTY, PLANT & EQUIPMENT

(a) Property, Plant & Equipment include:

	2007	2006
	\$	\$
Leasehold land & buildings – at cost	9,602,892	9,532,802
Less: accumulated depreciation	3,340,586	3,159,323
	<u>6,262,306</u>	<u>6,373,479</u>
Other fixed assets – at cost	1,626,033	1,514,986
Less: accumulated depreciation	1,304,367	1,190,297
	<u>321,666</u>	<u>324,689</u>
Work in Progress	293,599	-
Total – at cost	11,522,524	11,047,788
Less: accumulated depreciation	4,644,953	4,349,620
	<u>\$6,877,571</u>	<u>\$6,698,168</u>

NATIONAL RESERVE BANK OF TONGA**NOTES TO AND FORMING PART OF
THE FINANCIAL STATEMENTS
YEAR ENDED 30 JUNE 2007****11. PROPERTY, PLANT & EQUIPMENT – continued**

(b) Reconciliation of Property, Plant & Equipment

FIXED ASSETS	Land, Bldg & Improvement	Other Fixed Assets	Work in Progress	Total
At 30th June 2007	\$	\$	\$	\$
Opening net book amount	6,373,479	324,689	-	6,698,168
Additions	156,189	132,429	293,599	582,217
Transfers/Disposals	-	-	-	-
Depreciations	(267,362)	(135,452)	-	(402,814)
Closing net book amount	\$6,262,306	\$321,666	\$293,599	\$6,877,571

12. (a) FOREIGN CURRENCY DEMAND DEPOSITS

	2007	2006
	\$	\$
Accounts of International Organisations	1,493,460	4,483,429
Accounts of Domestic Organisations	3,253,112	2,659,486
	\$4,746,572	\$7,142,915

(b) LOCAL CURRENCY DEMAND DEPOSITS

	2007	2006
	\$	\$
Banks	20,658,726	12,110,849
Government of Tonga	24,511,450	27,920,990
	\$45,170,176	\$40,031,839

13. NATIONAL RESERVE BANK OF TONGA NOTES

	2007	2006
	\$	\$
Current	\$ -	\$1,494,668
	\$ -	\$1,494,668

14. CURRENCY IN CIRCULATION

The exclusive rights of national currency issue are vested with the Reserve Bank. Currency in Circulation comprises bank notes and coins issued by the Reserve Bank.

	2007	2006
	\$	\$
Notes	20,564,759	19,545,556
Coins	1,657,739	1,627,608
	\$22,222,498	\$21,173,164

NATIONAL RESERVE BANK OF TONGA**NOTES TO AND FORMING PART OF
THE FINANCIAL STATEMENTS
YEAR ENDED 30 JUNE 2007****15. STATUTORY RESERVE DEPOSITS**

The deposit represents the reserves required to be maintained by each financial institution under Section 39 of the NRBT Act 1988.

16. OTHER LIABILITIES

	<u>2007</u>	<u>2006</u>
	\$	\$
Other creditors and accruals	1,729,489	737,641
Provision for annual leave	48,360	36,672
Superannuation scheme	176,816	28,374
	\$1,954,665	\$802,687

The Bank administers the employees superannuation scheme and these funds are invested mainly in domestic securities. The fund is reconciled as follows:

Total of superannuation fund	839,816	691,374
Less: investment in domestic securities	663,000	663,000
	\$176,816	\$28,374

17. CASH AND CASH EQUIVALENTS

Cash and cash equivalents included in the cash flow statement comprise the following items in the balance sheet:

	<u>2007</u>	<u>2006</u>
	\$	\$
Cash on hand	20,341	71,756
Short term investments and current accounts	85,463,858	77,118,839
	\$85,484,199	\$77,190,595

18. RELATED PARTIES

In the normal course of operations, the Bank enters into transactions with a related party, the Government of the Kingdom of Tonga. The transactions include banking services, foreign exchange transactions and registry transactions. These transactions are carried out on normal trading terms.

19. COMMITMENTS AND CONTINGENCIES

Commitments and contingencies not otherwise provided for in the accounts and which existed at 30 June 2007 comprise:

- (i) Contracts for foreign exchange transactions was nil (2006: \$2,830,485.54)
- (ii) In accordance with the accounting policy in Note 2 (d) numismatic coins are not brought to account in the determination of the Bank's liabilities but a liability may arise if such coins are encashed for their face value. The Bank is of the opinion that in the unlikely event of encashment as legal tender, no significant loss is expected to arise.

NATIONAL RESERVE BANK OF TONGA**NOTES TO AND FORMING PART OF
THE FINANCIAL STATEMENTS
YEAR ENDED 30 JUNE 2007****20. FINANCIAL RISK MANAGEMENT**

The Bank identifies risks and implements controls in its operation and management of foreign reserves holdings. The main financial risks that the Bank faces are exchange rate risk, interest rate risk, credit risk, operational risk and liquidity risk

(a) Exchange Rate Risk Management

Exchange rate risk relates to the risk of loss arising from changes in the exchange rates against the Tongan Pa'anga. The Reserve Bank has adopted a currency risk management policy, which maintains the Tongan Pa'anga value of foreign reserves and minimizes the fluctuations in the Revaluation Reserve Account.

The value of the Tongan Pa'anga is determined by a basket of currencies. To minimize the exchange rate risk, the weights of the currencies in the exchange rate basket is the benchmark for the composition of the Reserve Bank's foreign currency assets.

(b) Interest Rate Risk Management

Interest rate risk refers to the risk of loss arising from changes in interest rates. The Bank limits interest rate risk by investing in short term investments of up to 12 months.

(c) Credit Risk Management

Credit risk relates to the risk of loss arising from the failure of counterparty to a transaction to perform according to the terms and conditions of the financial contract.

Credit risk or safety is a key criterion in the determination of the composition of the Reserve Bank's foreign currency assets.

To manage this credit risk, the Bank prescribes minimum credit ratings acceptable for investment and specifies the maximum permissible credit exposure to individual banks and countries. In addition, the number of commercial banks, with whom the Reserve Bank may deal with in foreign exchange must have minimum credit ratings of A.

The NRBT uses Standard and Poors credit ratings of assessing the credit risk of foreign counterparties. The credit ratings of counterparties are on "watch" all the time and are updated as new market information is available.

The concentration of credit risk in the Bank's investment portfolio is as follows.

	2007	2006
	\$	\$
Public Sector Securities – Local	16,008,832	16,241,832
Financial Institutions – Foreign	85,463,858	77,118,839
Total financial investments	\$101,472,690	\$93,360,671

NATIONAL RESERVE BANK OF TONGA**NOTES TO AND FORMING PART OF
THE FINANCIAL STATEMENTS
YEAR ENDED 30 JUNE 2007****20. FINANCIAL RISK MANAGEMENT – continued****(d) Operational Risk Management**

Operational risk relates to the risk of loss resulting from human error, lack of control or failure of internal processes and systems.

Managing operational risk in the Reserve Bank is an integral part of the day-to-day operations and oversight. This includes adherence to Reserve Bank's corporate policies and procedures. To minimize operational risk and manage compliance with Reserve Bank's corporate policies and procedures, the Reserve Bank outsources the internal audit function to be carried out at least once a year.

Operational risks in foreign reserves operations is minimized by a clear separation of duties between the front office (dealing) and the back office (settlement function). The front office comprises specialized officers (dealers) who are duly authorized to transact on behalf of the Reserve Bank. The back office comprises officers who independently process and settle all the deals undertaken by the front office.

In addition, operational risk is managed through monthly management meetings. Heads of Departments are required to report to the Governor any significant incidents that could adversely impact on the Reserve Bank.

(e) Liquidity Risk Management

Liquidity risk relates to the difficulty in raising funds at short notice to meet commitments.

Liquidity is a key criterion in the determination of composition of the Reserve Bank's foreign currency assets.

To minimize the liquidity risk, the Bank maintains an adequate level of reserves and taking into consideration the transaction demand on foreign exchange, ensures that an appropriate amount is maintained in current accounts at all times. The balance of the investible reserves are placed on term investments of up to 12 months. The composition of foreign currency assets is monitored daily.

The note below analyses the Bank's assets and liabilities into relevant maturity groupings based on the remaining period at balance sheet date to the contractual maturity date.

NATIONAL RESERVE BANK OF TONGA**NOTES TO AND FORMING PART OF
THE FINANCIAL STATEMENTS
YEAR ENDED 30 JUNE 2007****21. MATURITY ANALYSIS**

The table below analyses the Bank's assets and liabilities into relevant maturity groupings based on the remaining period at balance sheet date to the contractual maturity date.

MATURITY ANALYSIS - 30 June 2007

Maturity Analysis	0-3	3-12	1-5 Years	Over 5	No Specific	Total
	Months	Months		Years	Maturity	
	\$	\$	\$	\$	\$	\$
ASSETS						
Foreign Currency Assets						
Short Term Commercial Paper						
and Current Accounts	40,016,740	43,521,275	1,925,843	-	-	85,463,858
Accrued Interest	894,348	-	-	-	-	894,348
International Monetary Fund						
- Reserve Tranche Position	5,043,114	-	-	-	-	5,043,114
- Special Drawing Rights	1,108,574	-	-	-	-	1,108,574
- Currency Subscription	15,620,686	-	-	-	-	15,620,686
Local Currency Assets						
Cash on Hand	20,341	-	-	-	-	20,341
Accrued Interest	341,663					341,663
Domestic Securities	-	-	16,008,832	-	-	16,008,832
Other Assets	76,329	-	-	-	1,961,774	2,038,103
Property, Plant and Equipment	-	-	-	-	6,877,571	6,877,571
Total Assets	63,121,795	43,521,275	17,934,675	-	8,839,345	133,417,090
LIABILITIES						
Foreign Currency Liabilities						
Demand Deposits	4,746,572	-	-	-	-	4,746,572
Accrued Interest	31,217	-	-	-	-	31,217
Local Currency Liabilities						
Demand Deposits	45,170,176	-	-	-	-	45,170,176
NRBT Notes	-	-	-	-	-	-
Accrued Interest	417,498	-	-	-	-	417,498
Currency in Circulation	-	-	-	-	22,222,498	22,222,498
Statutory Reserve Deposits	-	-	-	-	25,544,000	25,544,000
IMF - Notes Currency						
Subscription	-	-	-	-	15,602,024	15,602,024
Other Liabilities	1,655,448	-	-	-	299,217	1,954,665
Total Liabilities	52,020,911	-	-	-	63,667,739	115,688,650
Liquidity Gap	11,100,884	43,521,275	17,934,675	-	(54,828,394)	17,728,440

NATIONAL RESERVE BANK OF TONGA**NOTES TO AND FORMING PART OF
THE FINANCIAL STATEMENTS
YEAR ENDED 30 JUNE 2007****21. MATURITY ANALYSIS - Continued****MATURITY ANALYSIS - 30 June 2006**

Maturity Analysis	0-3	3-12	1-5 Years	Over 5	No Specific	Total		
	Months	Months		Years	Maturity			
ASSETS								
Foreign Currency Assets								
Short Term Commercial Paper								
and Current Accounts	37,639,623	39,479,216	-	-	-	77,118,839		
Accrued Interest	1,586,134	-	-	-	-	1,586,134		
International Monetary Fund								
- Reserve Tranche Position	5,174,223	-	-	-	-	5,174,223		
- Special Drawing Rights	934,208	-	-	-	-	934,208		
- Currency Subscription	15,324,531	-	-	-	-	15,324,531		
Local Currency Assets								
Cash on Hand	71,756	-	-	-	-	71,756		
Accrued Interest	315,368					315,368		
Domestic Securities	1,023,000	-	15,218,832	-	-	16,241,832		
Other Assets	68,807	-	-	-	1,890,918	1,959,725		
Property, Plant and Equipment	-	-	-	-	6,698,168	6,698,168		
Total Assets	62,137,650	39,479,216	15,218,832	-	8,589,086	125,424,784		
LIABILITIES								
Foreign Currency Liabilities								
Demand Deposits	7,142,915	-	-	-	-	7,142,915		
Accrued Interest	22,535	-	-	-	-	22,535		
Local Currency Liabilities								
Demand Deposits	40,031,839	-	-	-	-	40,031,839		
NRBT Notes	1,494,668	-	-	-	-	1,494,668		
Accrued Interest	729,546	-	-	-	-	729,546		
Currency in Circulation	-	-	-	-	21,173,164	21,173,164		
Statutory Reserve Deposits	-	-	-	-	28,185,000	28,185,000		
IMF - Notes Currency								
Subscription	-	-	-	-	15,304,601	15,304,601		
Other Liabilities	638,276	-	-	-	164,411	802,687		
Total Liabilities	50,059,779	-	-	-	64,827,176	114,886,955		
Liquidity Gap	\$12,077,871	\$39,479,216	\$15,218,832	\$ -	\$56,238,090	\$10,537,829		

NATIONAL RESERVE BANK OF TONGA**NOTES TO AND FORMING PART OF
THE FINANCIAL STATEMENTS
YEAR ENDED 30 JUNE 2007****22. FAIR VALUES OF FINANCIAL ASSETS AND LIABILITIES**

The fair value of an instrument is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arms length transaction.

Quoted market values represent fair value when a financial instrument is traded in an organised and liquid market that is able to absorb a significant transaction without moving the price against the trader.

Financial Assets and Liabilities

The valuation of the Bank's financial assets and liabilities are discussed below:

Domestic Securities

The fair value of the Bank's domestic securities is TOP\$16.0m, based on quoted market prices.

Statutory Reserve Deposits

The carrying value of statutory reserve deposits are considered to approximate their fair value as they are denominated in cash.

Demand Deposits

The carrying value of deposits are considered to approximate their fair value as they are payable on demand.

Currency in Circulation

The carrying value of Currency in Circulation is considered to be its fair value as reported in the accounts.

Other Financial Assets and Liabilities

The reported values of other financial assets and liabilities are considered to be its fair value.

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