National Reserve Bank of Tonga

Annual Report 2010-11

Pangike Pule Fakafonua ʻo Tonga

ISSN 1018-8835

National Reserve Bank of Tonga

Annual Report for the Year Ended 30 June 2011

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

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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.

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Principal objectives and functions of the National Reserve Bank of Tonga

i) Principal objectives of the Bank

(1) The principal objectives of the National Reserve Bank of Tonga shall be, to:

(a) maintain internal and external monetary stability; and

(b) promote a sound and efficient financial system.

(2) Subject to subsection (1), the Bank shall conduct its activities in a manner that supports macroeconomic stability and economic growth.

ii) The principal functions of the National Reserve Bank of Tonga shall be, to:

(a) issue currency;

(b) formulate and implement monetary policy;

(c) regulate as required the supply, availability and international exchange of money;

(d) hold and manage the external reserves of the Kingdom;

(e) provide advisory services to the Minister on banking and monetary matters;

(f) be the principal banker, fiscal agent and depository of the Government;

(g) undertake banking business, in Tonga or elsewhere, subject to the provisions of this Act;

(h) regulate and supervise financial institutions; and

(i) oversee and promote the efficient, sound and safe functioning of the payment system.

Section 4 and Section 4A
National Reserve Bank of Tonga (Ammendment) Act, 2007

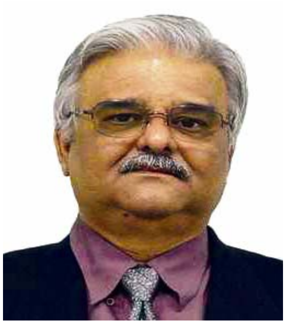
Board of Directors of the National Reserve Bank of Tonga during the year ended 30 June 2011

Mr Steve Edwards

Chairman

HRH Princess Salote Pilolevu Tuita

Director



Mr. Richard Prema

Director

Mr. Tiofilusi Tiueti

Director

Mrs. Siosi Cocker Mafi

Governor

Functions of the Board and the Governor

Board of Directors

The Reserve Bank has a Board of Directors comprising the Governor, Secretary for Finance and five other non-executive directors. Under the NRBT Act and the Amendment Acts, the Directors are appointed for five year terms by the Minister of Finance and may be reappointed. The NRBT Act was amended in October 2010 to separate the role of the Chairman of the Board from the Governor. In February 2011, the Minister of Finance and Cabinet appointed Mr. Steve Edwards as the new Chairman of the Board. Mr. Tiofilusi Tiueti, Secretary for Finance replaced Mr. ‘Aisake Eke as Director in October 2010.

The Board is responsible for the Reserve Bank’s policy and affairs and may issue directives for the purpose of giving effect to the provisions of the Act. The Board is to constantly review the performance of the Reserve Bank in the conduct of its functions and its use of resources, and may give advice to the Governor on any matter relating to the Bank’s functions and the exercise of its powers. The Board must meet at least once every two months. The Board of Directors held seven meetings during the year to discuss and formulate the policies of the Reserve Bank and to closely monitor its operations.

Governor

The Governor who is the Chief Executive Officer of the Bank is responsible to the Board for the execution of its policy and the management of the Bank. The Governor is appointed for a five-year term. Mrs. Siosi Cocker Mafi was reappointed in May 2008 as Governor of the National Reserve Bank of Tonga to a five year term.

Governor’s Forward

The Tongan economy continued to be affected by the prolonged impact of the global financial crisis through the continuing fall in remittances, credit contraction and stagnant exports. Domestic economic activity has been supported by foreign aid funded construction and infrastructure projects as well as tourism activity. However, rising oil prices and the uncertainty in the global economy posed major challenges to the economic and financial condition of the country and similarly to the conduct of the Reserve Bank’s monetary policy and prudential supervision policy.

Despite these challenges, the external balance of the country continued to improve, and stability and confidence in the financial sector was maintained. The level of foreign reserves continued to increase throughout the financial year reaching 7.7 months of imports at the end of June 2011. The receipts of official foreign aid from Tonga’s development partners and private capital inflows combined with suppressed domestic demand supported the official foreign reserves over the year. Inflation picked up on the back of rising food and fuel prices which had a significant impact on the domestic economy. After peaking at 9.7 percent in May 2011, annual inflation fell to 7.9 percent at the end June. Looking ahead, the level of foreign reserves will remain at adequate levels and inflation is projected to remain below 8 percent on the back of the IMF forecast that world oil prices will fall in the next 12 months. However, downside risks remain from the global economic uncertainty and financial volatility, and the country’s debt position which would continue to affect the outlook for the Tongan economy.

The National Reserve Bank of Tonga (NRBT) monetary policy primary objectives continued to focus on maintaining an adequate level of foreign reserves and promoting low and stable inflation. In 2010/11, the monetary policy stance remained accommodative. Despite the policy measures implemented by the Reserve Bank in 2009/10 to maintain a high level of liquidity in the banking system to support credit growth and stimulate economic activity, the banks’ balance sheet consolidation, tight credit conditions, and their focus on recovering of non performing loans continued to mute the effectiveness of these policy measures. The Reserve Bank’s monetary policy stance remained unchanged in 2010/11. The basis of the monetary policy decisions of the Reserve Bank are published on its six monthly Monetary Policy Statements.

In 2010/11, the financial system remained safe and sound. As the bank regulator and supervisor, the Reserve Bank continued its effort to reduce the vulnerability of the financial system to credit and liquidity risks to protect the interests of depositors. Proactive monitoring of the banks’ capital position continued during the year to ensure that the minimum risk weighted capital ratio is maintained at all times. The Reserve Bank continued to promote transparency by enforcing compliance with its disclosure requirements under Prudential Statement No. 4. During the year, stress tests were conducted internally focusing on credit and liquidity risk to ensure banks are able to withstand any further deterioration in their operations. The Reserve Bank continued to meet with the Association of Banks Tonga (ABT) to discuss issues that would support a sound and stable financial system. Given the significance of the Retirement Fund Board (RFB) in the banking system the Reserve Bank commenced quarterly meetings with the RFB to discuss matters that could affect the stability of the financial system.

During 2010/11, the Transaction Reporting Authority (TRA) in coordination with members of the National Committee and the Sub-Committee on Money Laundering and Terrorist Financing focused on the preparation and compilation of the Strategic Implementation Plan (SIP) for addressing the recommendations from the Mutual Evaluation report which was due in May 2011. The TRA continued working closely with members of the National Committee and the APG in ensuring that Tonga complies with Tonga's APG membership and the international requirements.

The Reserve Bank continued working towards maintaining the quality of notes and coins in circulation at a high standard. A review of the currency operations as well as public notices on counterfeit notes and consultations with the banks on maintaining a high quality of currency in circulation was conducted. During the year, the Reserve Bank continued its efforts to comply with the Information Technology (IT) Audit report recommendations in 2009, which included formalizing of the Reserve Bank's IT Policies and changing the Bank's network topology. The Reserve Bank continued updating the Bank's website with its publications, authorized statistics and press releases to inform its stakeholders and the public.

During the year, the Reserve Bank continued to strengthen its capacity building through supporting staff training on the job, in-house, locally and abroad. Staff participated in courses across a range of central banking functions to enhance their skills and the effectiveness and efficiency of their performances.

The annual accounts of the National Reserve Bank of Tonga continued to 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$235 million, an increase of 17.7 percent from the previous year mainly due to the increase in the level of official foreign reserves over the year. The Reserve Bank's net operating profit increased by 86 percent from the previous year to T$2.4 million.

I would like to thank the Board of Directors for their continued support and guidance during the year. I acknowledge the support from the Government of Tonga and the financial sector in ensuring that the stability of the financial system was maintained. I am grateful to the International Monetary Fund, World Bank, Asian Development Bank, Pacific Technical Assistance Centre (PFTAC), the Reserve Banks of Australia, New Zealand and Fiji, other regional central banks, the Bank of England Centre for Central Banking Studies, AusAid, NZAid and APG for technical assistances provided to the National Reserve Bank of Tonga in 2010/11. Finally, I extend my appreciation to the staff of the Reserve Bank for their efforts and dedication during 2010/11.

Siosi C. Mafi
Governor

NATIONAL RESERVE BANK OF TONGA

JUNE 2011

BOARD

GOVERNOR
Mrs. Siosi C. Mafi

DEPUTY GOVERNOR
Ms. Jessie Cocker

Manager, Accounts and Currency
Mr. Lata Tangimana

Assistant Manager, Accounts and Currency
Mrs Ma'ata M. 'Aho

A. Manage the issue and supply of currency

B. Ensure secure operation and storage of currency

C. Maintain quality and integrity of currency at international standard

D. Currency design and structure

E. Manage currency and numismatic for collectors market

A. Maintain accurate accounting records of all Banks' transactions

B. Payment and receipts of local and foreign currency transactions

C. Ensure financial statements are maintained at international standards

D. Manage annual budget of income and expenditures

E. Payment systems policy implementation

Manager, Administration and Information Systems and Technology
Miss Elizabeth Baker

A. General Administration

B. Personnel Administration, Safety and Occupational Health

C. Train and retain a professional team

A. Information Technology Management and Development

B. Information Systems Management and Development

C. Information Security Management

D. Staff Computer Training

A. Manage and Maintain Bank Premises, Plant & Equipment at international standard

B. Ensure Bank's Plant & Equipment operate effectively and efficiently

C. Ensure that the Bank's Premises, Plants and Equipment provide a pleasant, healthy and safe working environment for all employees, tenants and visitors

D. Assist the Security Unit in ensuring the security of all staff members, tenants and visitors

Guard Commander, Security Unit
Mr. Semisi Fifita

A. Ensure physical security of the Bank and its assets

B. Ensure security of the Bank and its assets are managed and maintained at international standards

Manager Financial Institutions and Markets
Miss 'Ungatea Latu

A. Licensing of Financial Institutions & Foreign Exchange Dealers

B. Bank Supervision – Onsite/Offsite Surveillance

C. Financial Regulations

D. Payment Systems Policy formulation

E. Transaction Reporting Authority – Anti money laundering & counter terrorist financing

F. Banking Statistics

G. Fraud

Assistant Manager, Financial Markets
Miss 'Isapela Hufanga

A. Manage Foreign Reserves

B. Manage and review Exchange Rate Policy

C. Implement Monetary Policy

D. Initiate Foreign Exchange Deals

E. Formulate and implement Exchange Control Policies

F. Registrar of Government Bonds

Manager, Research
Miss 'Anapuli Matoto

A. Monetary policy formulation and management

B Economic policy research and analysis

C. Management and development of economic and financial statistics

D. Dissemination of economic and financial information

E. Provide advisory services to the Minister on banking and monetary matters

Economic Overview

International Economic Developments

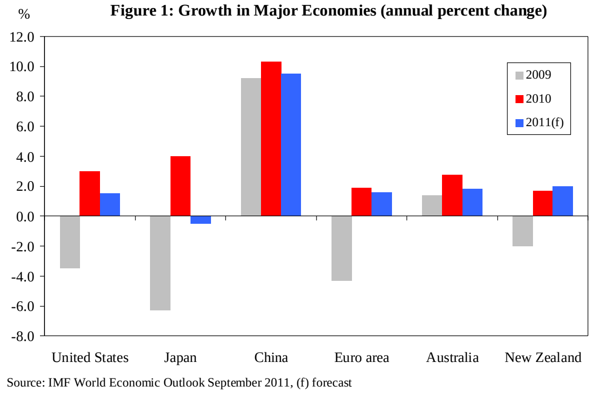
The global economy has slowed during the year, financial volatility has increased considerably and performance has continued to differ across regions. The IMF[1] estimated the global economic growth to have moderated to around 4 percent in 2011 from 5.1 percent in 2010. The slowdown reflects the weak growth in the United States with lack of a credible medium-term fiscal plan to reduce debt, the sovereign debt and banking sector problems in the euro area, the disruptions from the earthquake and tsunami in Japan, as well as the spreading unrest in the Middle East and North Africa region and the related surge in oil prices.

In the United States, the economy is struggling to gain a strong foothold with sluggish growth and a slow job recovery. Unemployment, currently at 9.1 percent, is expected to remain high through 2012. In Japan, the supply constraints from the March earthquake and tsunami have been easing, confidence has picked up and activity is starting to rebound. In China, activity has remained robust with domestic demand growing strongly contributing to high inflation. In much of advanced Europe, high public deficits and debt, lower potential output, and mounting market tensions are weighing on growth.

In the region, the Australian economy continued to benefit from the strong growth in Asia with high level of commodity prices contributing to growth. The Reserve Bank of Australia raised its policy rate in November 2010 by 25 basis points to 4.75 percent and has held the cash rate steady at 4.75 percent since then because of the uncertainty in the global outlook and the impact of floods and cyclones in late 2010 and early 2011 on economic activity. The Australian economy is estimated to have expanded by almost 2 percent in 2011. The New Zealand economy has performed relatively well underpinned by strong terms of trade. Rising consumer and business confidence have also stimulated domestic activity, which resulted in an increase in core inflation. The Reserve Bank of New Zealand raised its official cash rate by 25 basis points to 3 percent in July 2010 to dampen inflation. However, in February 2011 it reduced its official cash rate by 50 basis points to 2.50 percent to help offset the economic impacts of the Christchurch earthquake and to guard against the risk of the economy slowing sharply. Since then, economic activity has continued to expand. GDP growth is projected at almost 2 percent in 2011.

The Pacific Island countries (PICs) which were hit hard by the global crises have been recovering slowly although at different paces. Most PICs mainly the commodity importers have structural trade deficits on the account of high food and fuel prices. Conversely, the net commodity exporters have strong growth performance underpinned by the construction of a liquefied natural gas (LNG) project in Papua New Guinea, and strong mining and logging activity in the Solomon Islands. According to the IMF, the growth performance in the PICs appears to be strongly correlated to the business cycle in Australia and New Zealand. In particular, the strong appreciation of the Australian and New Zealand dollars supported PIC tourist sector in 2011.

Figure 1: Growth in Major Economies (annual percent change)

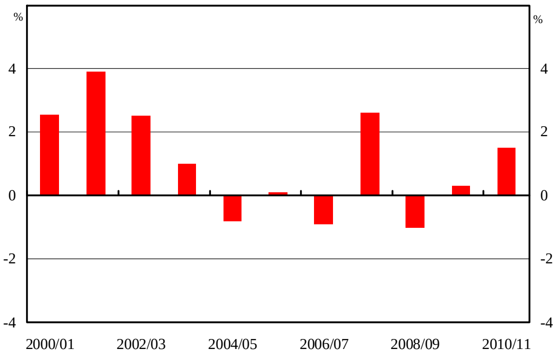


Source: IMF World Economic Outlook September 2011, (f) forecast

[1] IMF World Economic Outlook September 2011

Domestic Economic Conditions

Figure 2: Gross Domestic Product
Annual percent change



Source: Statictics Department and Ministry of Finance

Economic growth was estimated by the Ministry of Finance to expand further by 1.5 percent in 2010/11 from 0.3 percent growth in 2009/10. This continued to be driven by foreign aid funded construction and infrastructure projects as well as tourism activity. Despite the estimated positive growth, the economy is still weak and struggling to pick up the pace of economic activity. The impact of the global financial crisis is still evident through the continuing fall in remittances, the stagnant exports and the banks' tight lending conditions. Tonga's economic development will continue to be vulnerable to economic shocks and natural disasters which could hinder growth.

According to the Ministry of Agriculture and the Growers' Federation, some improvements were made in the agricultural sector in 2010/11, supported by the new agro-processing and post harvest plant in Tongatapu and Vava'u. The major agricultural exports which contributed to the improvement in the agricultural sector included coconuts, squash, sandalwood and root crops. Fish and other marine exports continued to remain subdued in 2010/11, affected by increasing fuel costs and the decline in fish stocks affected by climate change. The fall in harvesting of sea cucumber contributed to the decline in other marine exports.

Taro

Tungi Arcade

Construction and infrastructure activities increased during 2010/11 with the reconstruction of Nuku'alofa central business district and infrastructure development throughout Tongatapu. The major construction projects completed during the financial year included the extension of the Royal Palace, Taumoepeau Building, Royco, Sanft Building, Vaini new Police Station, Hu'atolitoli Prison and health centers in Tongatapu and Vava'u. Construction of new church buildings, new residential dwellings, and upgrading and renovation of schools also contributed to the growth in construction

Table 1. TONGA MAIN ECONOMIC INDICATORS [1/]					
		2007/08	2008/09	2009/10	2010/11
Real GDP	% change	2.6	-1.0	0.3	1.5
Tourist Arrivals (air & sea)	Thousands	67.1	71.7	63.3	n.a.
CPI (average)	% change	9.6	5.6	1.7	6.1
CPI (year-end)	% change	12.2	1.2	2.7	7.9
Money Supply (M3 - year end)	$m pa'anga	306.0	302.6	320.2	332.6
Domestic Credit (year end)	$m pa'anga	332.9	318.7	282.0	249.7
Weighted term deposit interest rate (year end)	% per annum	6.4	5.7	4.0	3.9
Weighted lending rate (year end)	% per annum	12.7	12.5	11.6	11.3
Merchandise exports fob (OET basis)	$m pa'anga	23.5	11.4	11.4	11.2
Merchandise imports fob (OET basis)	$m pa'anga	262.4	271.4	208.0	229.6
Official foreign reserves (year end)	$m pa'anga	89.1	136.3	170.5	203.8
Import coverage (year end)	Months	3.5	5.3	7.2	7.7
Exchange rate (period end)	US$/T$	0.5407	0.4967	0.5123	0.5912

Sources: Ministry of Finance, Ministry of Tourism, Department of Statistics and National Reserve Bank of Tonga

activity despite the fall in remittances and tightened banks lending conditions. At the same time, major construction projects funded by Tonga's development partners including the Vuna Wharf, the last phase of Vaiola Hospital, Tungi Arcade, Molisi Tonga, Prema and other infrastructure developments such as roads and drainage system are still ongoing.

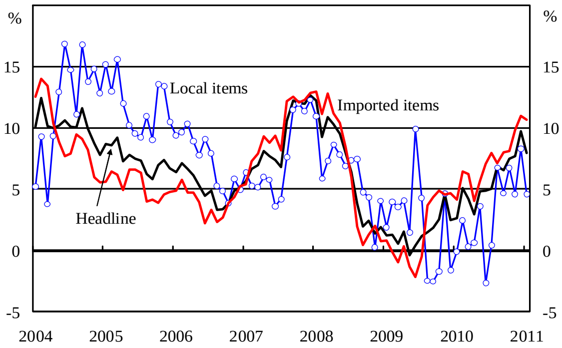
Construction of Vuna Wharf

The commerce, restaurants and hotels sector picked up in 2010/11, reflecting the improvement in tourism activity. Total arrivals into the Kingdom which includes air and cruise ship arrivals, and returning nationals rose by 0.5 percent in the year ended March 2011 compared to a 4.8 percent decline in the previous year. The increase in the total number of arrivals was mainly due to the rise in the number of cruise ships entering the Kingdom. However, tourism earnings reported by the commercial banks' overseas exchange transactions (OET) rose by 21.4 percent in the year ended June 2011 compared to 13.3 percent decline in the same period last year.

Prices

During the financial year 2010/11, the Statistics Department rebased the Consumer Price Index (CPI) to October 2010 from November 2002 based on its Household Income Expenditure Survey (HIES) 2009 report. Consequently, the weight of imported goods in the CPI was reduced to 58 percent from 66 percent while the domestic component increased to 42 percent from 34 percent.

Figure 3: Consumer Prices
Year-ended percentage change



Source: Statistics Department

The annual inflation as measured by the CPI increased significantly in 2010/11, peaking at 9.7 percent in May 2011, the highest since September 2008 before easing to 7.9 percent in the year ended June 2011. This was higher compared to 2.7 percent increase in the year ended June 2010. The rise in the headline inflation was mainly due to the increase in the prices of local and imported food, imported fuel and imported tobacco. The average annual inflation rate in 2010/11 was 6.1 percent compared to 1.7 percent recorded in the same period a year earlier. This was the highest average annual inflation rate since May 2009.

Imported inflation increased by 10.6 percent in the year ended June 2011, from 4.1 percent recorded in the previous year, mainly due to the rise in the prices of imported food, transportation and tobacco. The increase in imported fuel reflected the soaring global oil prices from an average of around US$76 per barrel in June 2010 to US$114 per barrel in June 2011 which outweighed the strengthening in the Tongan pa'anga against the US dollar. At the same time, the weakening of the Tongan pa'anga against the New Zealand dollar contributed to the rise in the prices of imported food from New Zealand, the main source of imported food for Tonga. The impact of imposing the government excise tax on imported tobacco and alcohol also contributed to higher imported inflation.

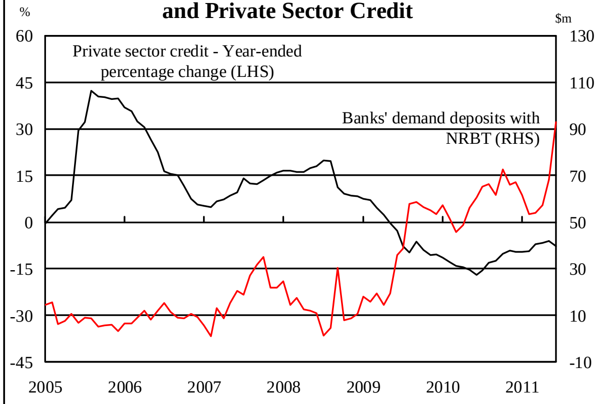
Domestic prices rose by 4.6 percent in the year ended June 2011 compared to 0.1 percent fall in the year ended June 2010. The major contribution to the rise in domestic inflation was the increase in the prices of local fruits and vegetables in the first half of 2011, reflecting the shortage in the supply of vegetables compared to the same period of the previous year. The increase in the price of electricity in June 2011 resulted from high world oil prices also contributed to the increase in domestic inflation during the year ended June 2011. In June 2011, the government subsidy of 11 seniti for the first 100 kilowatts until end of August 2011 to all electricity consumers assisted to control inflation.

Financial Intermediation

Total broad money (M3), a broad measure of money supply, increased by 3.9 percent in the year ended June 2011, which is lower compared to the 5.8 percent rise in the previous year. The increase in broad money was underpinned by increases in demand deposits and saving deposits by 10 percent and 11.4 percent respectively, in the year to June 2011, reflecting the increase in foreign reserves and liquidity in the banking system. On the other hand, term deposits fell at the end of June 2011, as investors utilised deposits to fund consumption.

Despite the excess liquidity available in the banking system during the financial year 2010/11, credit to the private sector continued to remain weak due to banks' tight lending conditions and lack of bankable project proposals received by the banks. However, the rate of decline in credit growth is slowing and there are signs of a pick up in new loan commitments. The contraction in banks' lending in 2010/11 reflected the banks' tightening credit criteria, the slow economic recovery, the settlement of a large private company loan, the impact of lending by the South Pacific Business Development (SPBD) Microfinance Ltd, and the write off of bad loans.

Figure 4: Banking Sector Liquidity and Private Sector Credit



Source: Licensed Financial Institutions and National Reserve Bank of Tonga

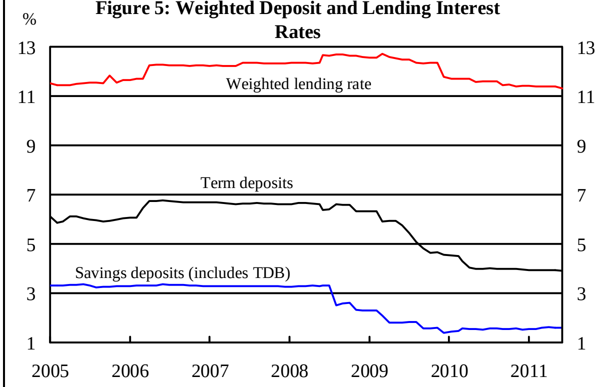
Total private sector credit growth slowed to negative 7.6 percent, year on year to June 2011 compared to the 16.9 percent contraction in the year ended June 2010. Business credit fell by 8.8 percent and household credit fell by 5.9 percent in the year to June 2011 compared with declines of 27.3 percent and 4.1 percent respectively in the year ended June 2010. Total credit to the private sector comprised 50.7 percent to the household sector and 49.3 percent to the business sector. However, when the disbursement of the loan from the People's Republic of China for the reconstruction of the buildings destroyed by the 2006 riots is accounted for, the overall credit growth to the private sector would have increased by 19.1 percent during the year ended June 2011.

The net credit position of government with the banking system improved in 2010/11 to $31.4 million from $28.1 million in 2009/10, reflecting the receipts of funds into government accounts from Tonga's development partners.

Interest Rates

In 2010/11, interest rates on deposits have been relatively stable, while lending rates trended downwards, reflecting high liquidity in the financial system and slow economic activity. Throughout the financial year, term and saving deposit rates offered by the banks remained unchanged. However, at the end of June 2011, the commercial banks' weighted average interest rates for deposits less than $50,000 on 3 to 48 months fell to 3.92 percent from 4.0 percent a year earlier as depositors moved to shorter term investment. In the same period, the lending indicator rate, a weighted average of interest rates across household and business lending, fell to 11.3 percent from 11.6 percent a year earlier. The fall in lending rates reflected the reduced rates offered by some of the banks during 2010/11.

Figure 5: Weighted Deposit and Lending Interest Rates



Source: Licensed Financial Institutions and National Reserve Bank of Tonga

External Developments

According to the Overseas Exchange Transactions (OET) data collected from the commercial banks, the substantial increase in the capital account surplus in the year to June 2011 more than offset the current account deficit and the net unrecorded outflows, which resulted in an overall balance of payment surplus and a significant increase in the level of official foreign reserves (Table 2). The deterioration in the trade deficit in 2010/11 reflected the increase in import payments by 10.4 percent to $229.6 million. The rise in imports was underpinned by higher payments for oil, reflecting the increase in international oil prices, as well as payments for the wholesale and retail sector. Exports remained stagnant at $11.2 million in the year ended June 2011. The slight decline in exports reflected the fall in both agricultural and fish exports due to a number of factors including high operation costs, failure to meet quality requirements by overseas markets, fewer market access and unfavorable weather conditions as indicated by growers and Ministry of Fisheries. The decrease in proceeds from sea-cucumber also contributed to lower earnings from other marine products although this was partially offset by the increase in the export of sandalwood.


Sandalwood

Net transfers fell by $28.1 million to $138.7 million in 2010/11 largely due to the fall in private remittances, by 7 percent to $146.5 million, reflecting the slow global economic recovery with high unemployment in the United States. The services account improved to $4.9 million surplus in the year ended June 2011 from $7.9 million deficit recorded a year earlier, reflecting the increase in tourist receipts. The net balance on investment income decreased slightly to $4.9 million from $5.3 million in 2009/10. These movements resulted in a widening of the current account deficit from $32.5 million to $69.7 million deficit in 2010/11.

The capital account surplus rose significantly by $81.0 million to $118.9 million in 2010/11, reflecting the receipts of Government foreign aid from development partners as well as a large one off capital receipts to a private company. The improvement in the capital account surplus more than offset the current account deficit and the unrecorded outflows which resulted in an overall balance of payments surplus of $33.3 million and a higher level of official foreign reserves. The gross official foreign reserves rose to a record high of $203.8 million at the end of June 2011, an amount equivalent to 7.7 months of imports.

Monetary Policy

In 2010/11, the Reserve Bank's monetary policy continued to focus on achieving its primary objectives of maintaining an adequate level of foreign reserves and promoting low and stable inflation. The promotion of low and stable inflation is a difficult task given the high component of imported goods in the country's economic activity. As such, the overall inflation of the country is highly vulnerable to imported prices, which is largely out of the Reserve Bank's control. Foreign reserves remained at comfortable levels throughout 2010/11, while inflation, after peaking at 9.7 percent in May 2011 generally trended downwards. Monetary policy continued to be accommodative during the year, leaving a high level of liquidity in the banking system.

Table 2. OVERSEAS EXCHANGE TRANSACTIONS (OET): Annual Summary	2007/08	2008/09	2009/10	2010/11
A. Merchandise trade balance	-238.9	-259.9	-196.6	-218.3
Exports, f.o.b.	23.5	11.5	11.4	11.2
Imports, f.o.b.	262.4	271.4	208.0	229.6
B. Services balance	-6.2	-5.4	-7.9	4.9
Receipts	70.1	83.7	71.8	89.0
Payments	76.3	89.1	79.8	84.0
C. Investment income balance	6.4	57.5	5.3	4.9
Receipts	13.0	61.0	14.7	13.1
Payments	6.6	3.4	9.4	8.2
D. Transfers balance	180.2	157.9	166.8	138.7
Receipts	203.6	177.7	183.3	149.6
Private	202.8	175.2	157.4	146.5
Official	0.8	2.5	25.9	3.1
Payments	23.4	19.9	16.5	10.9
Private	23.1	18.5	12.7	8.8
Official	0.3	1.3	3.8	2.1
E. Current account balance (A+B+C+D)	-58.6	-49.8	-32.5	-69.7
F. Capital account balance	69.0	69.6	37.9	118.9
Official capital	22.7	-11.0	8.4	63.5
Inflows	26.5	18.4	22.8	73.1
Outflows	3.7	29.4	14.4	9.6
Private capital	46.2	80.6	29.4	55.4
Inflows	50.5	88.9	38.0	77.7
Outflows	4.3	8.3	8.6	22.3
G. Other items, net	-12.9	27.4	28.8	-15.9
H. Overall balance (E+F+G) [1/]	-2.5	47.1	34.2	33.3

1/ Corresponds to changes in gross official foreign reserves.

Source: National Reserve Bank of Tonga

However, the desired outcome of the monetary policy measures implemented by the Reserve Bank in 2009/10 continued to be weakened by the banks' balance sheet consolidation and their focus on recovering of non performing loans. The Reserve Bank's monetary policy stance remained unchanged in 2010/11. The Reserve Bank continued to outline the basis of its monetary policy decisions through the publication of its six monthly monetary policy statements.

Economic Outlook

Domestic economic activity is anticipated to continue to be supported by foreign aid funded construction and infrastructure projects in 2011/12.

Breadfruit at HTFA

Agricultural exports are expected to improve following the establishment of the fumigation facilities in Vava'u and Tongatapu and the revitalization of the High Temperature Force Air (HTFA) at the airport. Construction activity will continue to support economic activity with the ongoing reconstruction of Nuku'alofa central business district, the new Vuna Wharf, the construction of the last phase of Vaiola Hospital, residential dwellings and infrastructure development.

Despite the expected slow recovery in the domestic economy, the global oil prices and world economic outlook remain uncertain. The level of foreign reserves is expected to fall but will remain above the adequate level of 3-4 months of import cover. Imports are projected to increase due to the planned construction projects for 2011/12 including the rebuilding of residential dwellings and hospital in Niuatoputapu that were destroyed by the tsunami in September 2009. The recent global economic uncertainty may result in the prolonged decline in remittances and affect the tourism sector which could exert downward pressure on the country's foreign reserves.

Inflation is expected to fall below the Reserve Bank's benchmark of 6 to 8 percent on the basis of the IMF forecast that world oil prices will fall. The expected decline in oil prices will contribute to lower imported inflation. The direct pass through of the expected fall in oil prices to transport and energy, and their feed through into the prices of food and other goods are likely to dampen domestic inflationary pressure. The movement in the exchange rates will also have an impact on imported inflation.

Given the expected fall in inflation, high levels of foreign reserves, the uncertainty in the global economy, and the weak domestic economic growth, the Reserve Bank will continue to promote macroeconomic stability through maintaining an accommodative monetary policy stance subject to maintaining adequate level of foreign reserves and promoting price stability.

Financial Markets

External Reserves

The management of the foreign reserves is one of the Reserve Bank's core functions. The Bank's foreign reserves investment policy is to obtain the maximum income commensurate with safety, liquidity and the maintenance of overall value which continued to be a challenge, given the uncertainty and volatility in the global financial markets. The continued European debt crisis and the ongoing global economic and financial crisis resulted in the relatively low international interest rates compared to the previous year. However, since the foreign reserves increased to record levels over the year, the income from the investment of the foreign reserves increased.

The gross official foreign reserves was maintained above the required level of 3 to 4 months of imports despite the 7 percent decline in remittances and the increase in imports of 9.6 percent over the year. This has contributed to maintaining market confidence by reducing the country's vulnerability to external shocks as well as ensuring that its foreign exchange needs and external debt obligations are met, given the prolonged impact of the global economic and financial crisis. The gross official external reserves ranged between 5.9 months and 7.4 months of import cover during the year. The level of gross external reserves increased from a low of $157.1 million to peak at $203.8 million and 7.4 months of import cover as at the 30th June 2011. This is compared with $170.5 million and 7.2[2] months of import as at 30 June 2010. The significant increase in the level of foreign reserves was attributed mainly to receipts for Government aid, a one-off private sector inflow, as well as deferred payments by businesses. The weak economy has suppressed domestic demand for foreign exchange. Despite the high level of foreign reserves, the Reserve Bank is concerned that the foreign reserves level may fall below 5 months of import when the repayment of the Government debt commences in 2013.

The risk parameters for the management of foreign reserves were updated and endorsed by the Board of Directors in October 2010. These risk parameters aim to ensure that credit, liquidity, foreign exchange and interest rate risks are managed within acceptable levels. A more pro-active approach to the management of the foreign reserves was adopted by the setting of internal trigger levels and measures to ensure safety as well as income subject to the maintenance of sufficient liquidity to meet the outflows. The Reserve Bank holds the foreign reserves mainly in US dollars, Australian dollars and the New Zealand dollars. During the year, the currency composition of the foreign reserves deviated from the benchmark portfolio currency composition but remained within the Board approved limit, in order to maximize income, meet the foreign exchange demands of the public and maintain the value of the foreign reserves. The Reserve Bank continued to closely monitor the international banks' credit ratings to ensure that the Reserve Bank's investments were held with banks that were rated above the Board approved minimum "A" rating by international credit rating agencies. Investments were also held in deposits with overseas central banks.

External Value of the Pa'anga

The Reserve Bank determines the rate at which the Tongan pa'anga is exchanged for foreign currencies on a daily basis by reference to a weighted basket of currencies of Tonga's major partners in foreign trade and foreign receipts and payments transactions. This rate is set on a daily basis and is used by the commercial banks and licensed foreign exchange dealers to establish the exchange rates for their customers.

During the year, reviews of the exchange rate currency basket were completed with a technical assistance from the IMF and ADB Pacific Economic Management program (ADB/PEM). Based on the

[2] Revised from 7.1

Consultants' reports, the Board of Directors approved in May 2011 the framework for the exchange rate basket and its annual review. The IMF Article IV Mission assessed Tonga's exchange rate to be broadly in line with levels suggested by medium-term fundamentals. The mission also considered the current exchange rate basket weights to be broadly appropriate, and supported the proposed annual review of the weights in order to ensure that they are consistent with changes in trade patterns and the emergence of renminbi debt.

The Reserve Bank monitors the movement of the rate of exchange of the pa'anga against other currencies with a view to ensuring that the country's balance of payments position and price stability are maintained at levels that are consistent with the achievement of macroeconomic stability. The Reserve Bank may also make adjustments to the Tongan pa'anga exchange rate to enable the Reserve Bank to react in a flexible manner to external and internal shocks. These adjustments continued during 2010/11. The external value of the pa'anga ranged between US$0.51 and US$0.59, during 2010/11, compared with US$0.50 to US$0.53 in 2009/10. The Nominal Effective Exchange Rate (NEER) increased by 3.0 percent over 2010/11 which reflected the strengthening of the Tongan pa'anga against the currencies of its major trading partners. The strengthening of the Tongan pa'anga against the US dollar was attributed mainly to the strengthening of the Australian dollar. The pa'anga fluctuated between AUD0.53 to AUD0.59 and NZD0.70 to NZD0.73 in 2010/11 compared with a range of AUD0.55 to AUD0.61 and NZD0.71 to NZD0.76 respectively in 2009/10, reflecting reduced volatility in the NZD during the year.

The Real Effective Exchange Rate (REER) rose by 0.1 percent over the same period as Tonga's inflation was higher than its trading partners during the year.

The application of the agreed limits on the exchange rate spreads of banks and foreign exchange dealers continued during the year. This has contributed to promoting competitive exchange rates being offered to the public. The Reserve Bank continued to respond to official requests for quotes on exchange rates and continued to publish the commercial banks and licenced foreign exchange dealer's exchange rates weekly and monthly on the Reserve Bank's website, to improve public access to exchange rate information.

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 mainly the Government, and for its own account, in a range of currencies. The Reserve Bank was a net purchaser in the spot foreign exchange markets during the year. Foreign exchange purchases of T$210.8 million exceeded sales of T$178.0 million giving a total foreign exchange turnover for the year of T$388.8 million, an increase from T$296.4 million in the previous year.

Exchange Control Operations

During 2010/11, the Reserve Bank processed 970 exchange control applications for payments of amounts above the delegated limits and all capital payments as stipulated in the Exchange Control guidelines. The approved exchange control applications amounted to T$218.4 million in 2010/11 (of which 11 percent were classified as capital transactions) compared to the 860 exchange control applications (13 percent capital transactions) processed in 2009/10 amounting to T$194.2 million. The increase in exchange control applications is in line with the increase in demand for imports and increased oil import payments. The decrease in the proportion of capital payments over the year largely reflects the decrease in loan repayments due mainly to the bringing onshore of major foreign currency loans in the previous year. The exchange control data on foreign currency payments by large importers are key inputs to the Reserve Bank's foreign reserves forecast and monetary policy decisions. The Reserve Bank also received 11 applications for the removal of foreign currency cash over T$10,000 across the border, of which all applications were approved totaling T$1.3 million. This is a decline from 19 applications totaling T$6.8 million in 2009/10 which may be attributed to favourable exchange rates offered locally or due to increased use of foreign cards.

The annual review of the Exchange Control policy was completed in June 2011 and the Board of Directors approved revisions to the Exchange Control Policy Guidelines to be effective in July 2011. The revisions included consideration of the recommendations from the report of the Parliamentary Select Committee on Financial Matters 2010, feedback from the Ministry of Revenue regarding the tax clearance requirement, the current practice and to improve the clarity of the requirements as a result of the consultation with banks and foreign exchange dealers. The revisions also included the increase in the delegation limit on current payments from T$50,000 to T$100,000 and tax clearance is only required for payments that have tax implications.

Spot checks were undertaken during the year to ensure banks and licenced foreign exchange dealers were compliant with the exchange control guidelines. Enhanced spot checks are to be conducted following the increase in the delegation limit. The Reserve Bank conducted training for the commercial banks and foreign exchange dealers to improve their understanding of its exchange control requirements.

Export Proceeds

Since early 2010, the Reserve Bank worked towards developing a framework for the return of export proceeds to Tonga. A study was commissioned in April 2010 to consult the exporters and other relevant stakeholders on the reasonable timeframe and amount of export proceeds to be repatriated back to Tonga. The Reserve Bank engaged the Reserve Bank of Fiji's assistance in January 2011 to share their experience and provide practical advice on the best way to set up a framework for the return of export proceeds to Tonga. The result of the Consultants findings and recommendations revealed the need to review the Foreign Exchange Control Act and Regulations with the aim of incorporating a legal framework in which an export proceeds monitoring regime could be established. The Reserve Bank has corresponded and met with relevant Government officials in the process of setting up the framework. Work continues on implementing the recommendations by the Consultants.

Domestic Market Operations

Since the Reserve Bank's monetary policy stance remained unchanged, there were no Reserve Bank notes issued during the year 2010/11. This is to maintain excess liquidity in the banking system to encourage banks to lend and support economic activity.

Registrar of Government Securities

As the registrar of Government securities, the Reserve Bank rolled over 2 Government of Tonga Bonds which matured in June 2011 and issued 1 new Government of Tonga Treasury Notes in September 2010 for six months. The Treasury Notes was rolled over in March 2011 for another three months maturing in June 2011. During the year, the Reserve Bank processed a total of $50,000 Government bonds for early redemption by bond holders and resold these in the secondary market. At the end of June 2011, the total value of Government of Tonga Bonds outstanding was $29.45 million, unchanged from the previous year.

Operations with Licensed Financial Institutions

In order to improve the effectiveness and efficiency of its liquidity management function, the Reserve Bank analysed and forecast banking system liquidity and continued to publish the total banking system liquidity on its website as well as the total banking system's holdings of eligible securities for short term secured borrowings or repurchase agreement with the Reserve Bank. These securities include the Reserve Bank Notes and Government of Tonga Bonds and Treasury Notes. As at the 30th of June 2011, the banking system liquidity stood at $112.5 million, this comprised of $94.2 million in the banks' exchange settlement accounts held with the Reserve Bank and $18.3 million of Government of Tonga Bonds held by the banks. This is compared with total liquidity of $78.9 million at the end of June 2010. The higher liquidity this year was in line with the higher level of foreign reserves and increased investment by the banks in government securities during the year.

Due to the excess liquidity in the financial system, there was no activity in the inter-bank market and therefore no need for any repurchase agreements during the 2010/11 financial year. In October 2010, the annual interest rate on the Reserve Bank Repurchase Agreement Facility was increased from 1.9 percent to 3.9 percent per annum. This revision was to peg the repo rate to the inter-bank lending rate plus a margin of 200 basis points. This was in recognition of the improvement in banking system liquidity and the need to revert the Repo facility back to the normal structure.

Licensing Authorised Foreign Exchange Dealers

As at the 30th June 2011, the Reserve Bank have licensed 4 authorized foreign exchange dealers and registered 4 restricted foreign exchange dealers. The Reserve Bank received applications for the renewal of all 8 foreign exchange dealers of which were all renewed. In September 2010, the registration of one foreign exchange dealer was cancelled due to non-compliance with the requirement to set up office in Tonga within 6 months of its registration.

During the year, the Reserve Bank continued to be active in requiring businesses that were conducting foreign exchange business without a licence to apply for a licence. The Reserve Bank received two applications for an authorized foreign exchange dealer licence and one application for a restricted foreign exchange dealer registration, and two were still being processed by the end of June 2011 while one application was withdrawn by the applicant. All licences and registrations are due for renewal on the 31st December of every year. Applications for the renewal of licences or registrations shall be submitted one month prior to the expiry of the licence or registration.

The Reserve Bank conducted compliance spot checks, quarterly meetings and training of the authorized restricted foreign exchange dealers to improve the framework for monitoring of compliance with the conditions of licence / registration and to assist the annual licence/registration renewal process. The Reserve Bank continued to liaise with the Ministry of Labour Commerce and Industries to coordinate efforts and to facilitate the procedures for licensing of foreign exchange dealers and to ensure all businesses conducting foreign exchange business are licenced by both authorities.

Financial Sector

The Reserve Bank is responsible for the promotion of a sound and efficient financial system. These objectives are pursued through the licensing, regulating and supervising of financial institutions (banks).

There are 4 banks licensed to operate in Tonga.

	Branches (including Head Office at Nuku'alofa, Tongatapu)	**ATMs**	**Internet Banking**	**Other services**
Australia and New Zealand Banking Group Limited (ANZ)	3	11	Yes	Customer Experience Portal
Westpac Bank of Tonga (WBOT)	5	8	Yes	Financial Education Programs – Financial First Steps Program, Women in Business Program, Business Basics Program
MBf Bank Limited	2	-	No	-
Tonga Development Bank (TDB)	6	-	No	Microfinance

Due to the slow recovery in the domestic economy, the banks continued with its current banking services with only a few new services introduced during the year. ANZ advised that it will launch an ANZ Pacific Money Transfer Card soon to promote lower costs for remittances. In June 2011, a Customer Experience Portal program was introduced whereby customers can file complaints/ compliments that will assist with improving customer service. In July 2010, ANZ’s rural banking services ceased operations given the small number of customers utilizing this facility as well as the bank’s concerns for the safety of its staff transporting cash in rural areas.

The Westpac Bank of Tonga and the Tonga Development Bank maintained their head office and branches on Tongatapu as well as branches on the islands of Vava’u, Ha’apai, and ‘Eua. The MBf Bank Limited maintained their head office on Tongatapu and a branch on the island of Vava’u. The ANZ Bank also maintained their head office on Tongatapu, a branch at Ma’ufanga, and a sub-branch on Vava’u. Tonga Development Bank continued to be the only bank serving the outermost islands of Niuatoputapu and Niuafo’ou and providing microfinance services.

The Westpac Bank of Tonga continued to provide the “Financial First Steps Program” and “Women in Business” program, and launched a new “Business Basics Program” in October 2010, which are financial education programs on how to manage money. These were co-funded by the Australian Aid and were open to customers of the other banks as well as the outer islands. Meanwhile, the Tonga Development Bank continued to provide its Business Advisory training program for many of its small business customers.

The National Reserve Bank of Tonga is vested with the powers to licence Banks under Section 8(2) of the Financial Institutions Act 2004. During the year, the Reserve Bank met with persons inquiring about a licence to conduct banking business in Tonga and were provided with information on the process and procedures to apply for a bank license. This information is also found on the Reserve Bank website. By the end of the financial year the Reserve Bank did not receive any formal application for a licence to conduct banking business.

Supervision and Regulation of Licensed Financial Institutions

The Reserve Bank is required under section 15(1) of the Financial Institutions Act 2004 to undertake the prudential supervision of licenced financial institutions in order to maintain public confidence in the operation and stability of the financial system and to protect the interests of depositors.

Despite the prolonged impact of the global economic and financial crises, the continuation of the decline in remittances and weak economic activity, Tonga’s banking system remained sound and stable. In 2010/11, the banking system maintained a strong capital and liquidity position and slightly improved earnings and asset quality over the year. The focus of bank supervision therefore was on credit and liquidity risk management and the disclosure of interest rates.

During 2010/11, the Reserve Bank continued to focus its supervisory activities on banks’ interest rates following the significant impact of the global economic and financial crises on Tonga’s economy through the significant decline in private remittances in the past 2 years. The level of interest rates in Tonga was also one of the main concerns raised by the Parliamentary Select Committee on Financial Matters in August 2010. During 2010/11, the banks reduced their lending interest rates by up to 2.4 percent while there were no changes in their deposit rates compared to reductions of up to 4.5 percent and 3.25 percent respectively in the previous year. High liquidity and increased competition in the banking system are expected to drive the loans interest rates lower.

In March 2011, the Pacific Financial Technical Assistance Centre (PFTAC) completed its review of interest rate spread in the Pacific region which showed that the lending rates and interest rate spread in the South Pacific countries including Tonga are generally in line with comparable economies after taking into account likely determinants of interest rates such as country risk, credit risk and shallow financial markets. The PFTAC report was accepted by the Forum Economic Ministers’ Meeting in Samoa in July 2011 and this report has been released and posted by the PFTAC on its website for public information.

The Reserve Bank continued its effort to reduce the vulnerability of the financial system to credit and liquidity risks and implication on the capital position. The Reserve Bank met with the banks to ensure that they have adequate credit and liquidity risk management systems. This was to avoid the repetition of the liquidity shortage in past years. The fall in remittances and slow down in the economy continued to contribute to the slow recovery of non-performing loans in the banking system. Ongoing proactive monitoring of the banks’ capital position therefore continued. During the year, stress tests were conducted internally focusing on credit and liquidity risk to ensure banks are able to withstand any further deterioration in their operations.

Onsite examinations of banks, which are an integral part of the Reserve Bank's supervisory framework, were undertaken. Two onsite examinations were conducted focusing on credit and liquidity risks and verifying compliance with the Reserve Bank's reporting requirements. A special onsite visit to one of the banks was also conducted to review its capital position. The recommendations arising from these visits and prior onsite visits were monitored throughout the year.

The Reserve Bank continued to meet with the Association of Banks in Tonga (ABT) to discuss issues which would support the soundness and stability of the financial system. These issues included head office oversight, capital adequacy, asset quality, interest rates and liquidity in the banking system as well as reporting issues. The discussions at these meetings have also assisted in bringing out important issues that should be raised with the Government to reduce the risks of lending in Tonga and thereby reduce the lending interest rates, and at the same time ensure the safety and security of depositors' funds are protected. This included facilitating a meeting between the ABT and the Royal Land Commission to discuss land issues and its contribution to the economic development of the country. Other positive developments for the banking system include the passing of the Personal Properties Securities Act in September 2010 and the setting up of the Personal Property and Security Assets registry which became live in April 2011. The ABT is continuing to work on setting up of a credit bureau. These developments should improve transparency and the credit and lending environment in Tonga.

The Reserve Bank continued to hold regular meetings and trainings with banks in order to discuss and clarify the quality of reporting in terms of accuracy and timeliness. Administrative penalties were levied on banks due to recurring wrong reporting and late submission of returns. Furthermore, proposed revisions to the prudential returns were issued to banks for comments as a result of the Reserve Bank's participation in the IMF PFTAC's project to standardize the prudential returns in the Pacific region to improve accuracy.

The Reserve Bank also continued to improve the enforcement of the Prudential Statements by conducting annual compliance checks as well as spot checks of compliance with the disclosure requirements under Prudential Statement No. 4. The banks have been given time to ensure full compliance with the requirements of all the eleven Prudential Statements.

During the year, the Reserve Bank commenced its quarterly meetings with the Retirement Fund Board (RFB) given its significance in the financial system.

Technical assistance was funded by the IMF/PFTAC and the Reserve Bank during the year to strengthen the Bank's supervisory framework whereby these technical advisors conducted training of the Bank Examiners and contributed to enhancing the offsite monitoring tools, as well as assisting with the onsite visits to the banks. The Reserve Bank also enhanced its supervisory capacity by recruiting another Bank Examiner. The Reserve Bank also benefited from the assistance from the Australian Prudential Regulation Authority (APRA), the Australian banks' home supervisor, through training on onsite examination and improvement in information exchange between the host and home supervisors.

The Reserve Bank continued to be the custodian for the business recovery and private sector reconstruction facilities, funded by the Australian and New Zealand Governments. As at the end of June 2011, the balance of the private sector reconstruction facility was at T$6.5 million compared to T$9.1 million in the previous year due to drawdown for approved customers during the year. The due date for any new loan application under this facility had expired in December 2009.

Financial Performance

The total assets of the financial system increased by $18.8 million to $450.7 million in 2010/11, an increase of 4.4 percent over the year. The growth in the banks' assets was mainly due to a significant increase of $36.8 million in the Exchange Settlement Accounts (ESA) and an increase in other assets by $8 million due to major audit adjustments. Total net loans (total gross loans net off total provisions) by the banks to the non-financial sector, on the other hand, fell by $25.1 million (9.5 percent) compared with a decrease of $42.4 million (13.8 percent) recorded in 2009/10. The decline in net loans reflected the settlement of major loans and the continued consolidation and clean up of the banks' balance sheet during the year. At the end of 2010/11, the banks' outstanding loans portfolio comprised of loans to industries and businesses including agriculture (46.7 percent) and private individuals (48.3 percent of which 34.9 percent was for housing).

Table 3. FINANCIAL SECTOR DEPOSIT ACCOUNTS

	2006/07	2007/08	2008/9	2009/10	2010/11
Demand Deposits					
Number of Accounts	2,657	2,687	2,650	2,469	2,508
Value of Deposits ($m)	66.7	66.4	70.0	80.0	88.6
Saving Deposits					
Number of Accounts	45,816	44,486	43,547	36,004	39,919
Value of Deposits ($m)	54.1	53.7	48.8	51.9	57.5
Time Deposits					
Number of Accounts	1,710	1,747	1,489	1,489	1,524
Value of Deposits ($m)	130.5	165.8	161.6	157.5	145.1
Total Number of Accounts	**50,183**	**48,920**	**47,686**	**39,962**	**43,951**
Total Value of Deposits ($m)	**251.2**	**286.0**	**280.3**	**289.4**	**291.2**

Source: Licensed Financial Institutions

Total liabilities increased by $6.9 million (2 percent) due mainly to an increase in provision for non-lending losses by the banks of $4.5 million. Total deposits by non-financial sector grew slightly by $1.8 million (0.6 percent) to $291.2 million in 2010/11 while the total number of accounts reported increased by 10 percent to 43,951 (Table 3). Similarly, investment in TDB promissory notes increased by $3.4 million (12.8 percent) in 2010/11. The increase in deposits and the slow down in lending to the private sector have contributed to the high level of liquidity in the banking system. Total borrowing by the banks from other financial institutions, on the other hand, decreased by $9.1 million (79 percent) following the conversion of a major utility foreign currency loan to local currency. Dividend payable decreased by $4.3 million as a result of the transfer of one bank's dividend payable to general reserves during the year.

Profitability

The profitability of the total financial sector turned around in June 2011 compared to the significant losses recorded since 2008/09. The total financial sector as a group showed an annualised pre-tax profit of 1.8 percent in 2010/11, a marked turnaround from a pre-tax loss of 1.3 percent in 2009/10 (Table 4). The notable improvement in profitability reflect the significant decrease in loan loss expenses to 1.2 percent of average assets in 2010/11 compared to 4.8 percent in 2009/10.

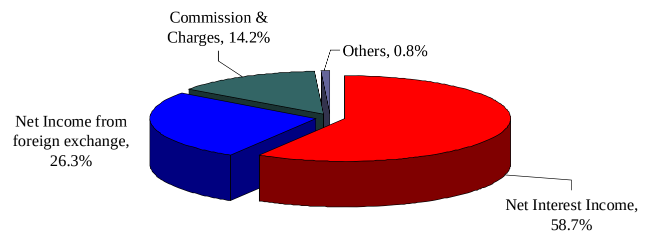
Table 4. FINANCIAL PERFORMANCE

	2006/07 1/	2007/08 1/	2008/09 1/	2009/10 1/	2010/11
Pre-tax Net Profit (% average total assets)	1.1	2.3	-6.7	-1.3	1.8
Total Operating Income (% average total assets)	11.1	10.4	9.1	9.8	10.4
Net Interest Income (% average total assets)	5.4	4.6	4.5	5.1	4.6
Non-interest Income (% average total assets)	4.6	4.6	3.4	3.3	4.3
Average Net Interest Margin (%)	7.9	6.9	6.5	7.9	7.7
Total Operating Expenses (% average total assets)	5.9	5.6	6.0	6.3	7.4
Consolidated Risk-weighted Capital Ratio (%)	20.7	21.4	26.1	22.2	26.3

1/ Revised to reflect annualised data
Source: Licensed Financial Institutions

Total operating income increased to 10.4 percent of average assets from 9.8 percent in 2009/10. The increase in operating income was attributed mainly to the increase in non-interest income to 4.3 percent of average assets from 3.3 percent in the previous year. Net income from foreign exchange activities and commission income increased to 26.3 percent and 14.2 percent of average assets respectively in 2010/11 from 21.6 percent and 10.3 percent respectively in the previous year. Net interest income was 4.6 percent of average assets, slightly decreased from 5.1 percent in 2009/10 reflecting mainly the reduction of banks' lending interest rates as well as the minimal lending during the year. Accordingly, the average net interest margin (net interest income as a percentage of average earning assets) for the banks slightly decreased to 7.7 percent in 2010/11 compared with 7.9 percent in 2009/10 and the net interest rate spread slightly decreased to 4.0 percent from 4.5 percent in 2009/10. The bulk of banks' operating income was derived from the extension of loans, the composition of net interest income declined to 58.7 percent of total operating income in 2010/11 compared with 66.8 percent in 2009/10.

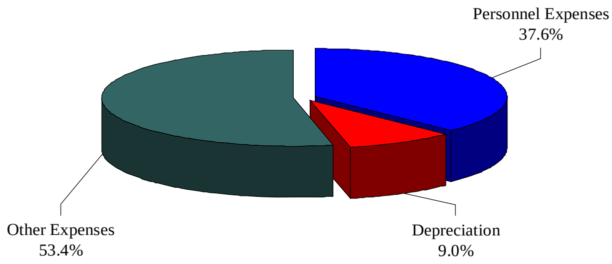
Figure 6: Financial Sector - Components of Total Operating Income - June 2011



Source: Licensed Financial Institutions

The operating expenses of the banks increased to 7.4 percent of average assets in 2010/11 compared to 6.3 percent in 2009/10. This was mainly due to an increase in the banks' personnel expenses over the year. About 37.6 percent of administrative expenses of the banks were taken up by employees' remuneration, an increase from 35.4 percent in the previous year. Depreciation and amortisation accounted for 9 percent of total administrative expenses and the balance of 53.4 percent was made up of the purchase of various goods and services necessary for the operations of the banks.

Figure 7 : Financial Sector - Components of Total Operating Expenses - June 2011



Source: Licensed Financial Institutions

Liquidity

Liquidity in the banking system continued to remain at high levels in 2010/11 underpinned by the continued contraction in credit growth as well as the increase in deposits, which was also in line with the high level of foreign reserves. Net loans as a proportion of deposits[3] decreased to 74.5 percent from 83.6 percent in 2009/10. Furthermore, the Liquid Asset Ratio increased to 35.6 percent from 27.3 percent in 2009/10, which was well above the minimum Reserve Bank requirement of 5 percent.

Capital

The capital position of the banking industry remained strong and above the minimum ratio required by the Reserve Bank. The consolidated risk weighted capital ratio for all the banks increased to 26.3 percent at the end of June 2011 compared with 22.2 percent at the end of June 2010. The increase in the capital adequacy ratio over the year was attributed mainly to the improvement in banks' profitability as well as the transfer of dividend payable to capital by one of the banks during the year. The continued minimal growth in loans is also supporting the maintenance of a relatively high risk weighted capital adequacy ratio.

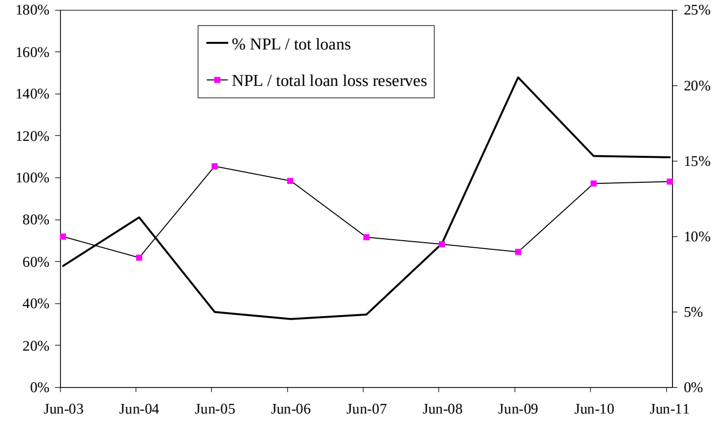
Asset Quality

The overall quality of the banks' assets slightly improved in 2010/11 as total non-performing loans decreased by $4.5 million (9.4 percent) to 15.2 percent of total loans compared with 15.3 percent at the end of June 2010. The total non-performing loans comprised of loans to businesses (69.8 percent) mainly the tourism and retail and wholesale sectors and the private individuals (30.2%), mostly for housing (23.3 percent). The improvement in asset quality reflects the settlement of major exposures from the receipt of proceeds by a private company in June 2011 as well as the write-off of non-performing loans. The weak economy and inadequate secondary market for security properties

[3] Deposits = non-financial sector deposits + TDB promissory notes

contributed to the slow recovery of non-performing loans. Provisions against loans decreased by $3.8 million (8.3 percent) over the year. This reflected the write back of provisions following the settlement and write off of provisioned non-performing loans during the year. This contributed to a slight improvement in the coverage ratio of non-performing loans to total loan loss reserves to 98 percent from 97 percent at the end of June 2010.

Figure 8: Financial Sector - Non Performing Loans - Coverage Ratio - June 2011



Source: Licensed Financial Institutions

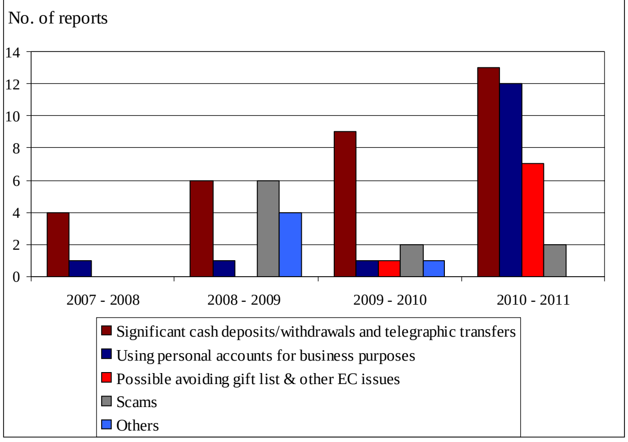
Transaction Reporting Authority

The Reserve Bank is the Transaction Reporting Authority (TRA) under the Money Laundering and Proceeds of Crime Act and performs functions similar to the functions of the Financial Intelligence Units (FIU) in other countries. These functions include combating money laundering and terrorist financing in Tonga by enhancing awareness and ensuring risk management systems are in place.

During the year, the TRA focused on the preparation of the Strategic Implementation Plan (SIP) for addressing the recommendations from Tonga's Mutual Evaluation report which was due in May 2011. This included a stock-take of the non-supervised financial institutions and cash dealers and conducting an AML risk assessment of the financial sector. The TRA and the members of the National Committee and the Sub-Committee on Money Laundering and Terrorist Financing worked together in compiling the SIP. The authorities were assisted through a SIP workshop in November 2010 in Wellington, New Zealand, and an in-country workshop facilitated by the Asia Pacific Group on Money Laundering (APG), Australian Transaction Reports and Analysis Centre (AUSTRAC) and the Pacific Islands Forum Secretariat (PIFS) and co-hosted by the TRA and the Crown Law Department which took place in April 2011. Since the adoption of Tonga's Mutual Evaluation report in July 2010, a progress report was presented to the APG's annual meeting in July 2011. The APG plenary agreed that there has been satisfactory progress therefore Tonga is subject to a regular follow-up with progress reports to be provided on an annual basis. The progress since the MER included the enactment of the amendments to the Money Laundering and Proceeds of Crime Act in September 2010 and the new MLPC Regulations 2010. The TRA will continue to work closely with members of the National Committee and the APG in working towards complying with Tonga's APG membership and the international requirements.

The commercial banks and licenced foreign exchange dealers reported a total of 34 suspicious transactions (STR) to the TRA during the year, a notable increase from 14 in the previous year reflecting improved awareness by the banks and licenced foreign exchange dealers. Thirteen of the 34 STRs were related to significant cash deposits, withdrawals or telegraphic transfer transactions that were not in line with the customers' normal course of business or the source of funds were not determined. This continues to be the dominant STR indicator similar to the previous years and the TRA is working together with the banks and licenced foreign exchange dealers to ensure enhanced

Figure 9: Suspicious Transaction Reports by type - June 2011



ongoing monitoring of such transactions for any suspicious activity. Twelve of the 34 STRs were related to the usage of personal accounts for business transactions, which is a marked increase from one case reported in the previous year. This shows that the banks are more aware of possible tax evasion by businesses and the need to report them to the TRA for further investigation. Seven STRs were related to possible avoidance of the exchange control limit on gift payments which have been dealt with by the Exchange Control Unit. Two STRs were related to scams, similar to that in the previous year. The TRA continues to be concerned with the increasing internet scams and continued to issue public notices on such scams. Thirty two of the 34 were reported to the Police (TCU) for further investigations, fourteen were reported to the Ministry of Revenue for possible tax evasion and one was reported to the MLCI for business licensing purposes.

The TRA also continued to disseminate the terrorist list from the Office of Foreign Assets Control's (OFAC) of the United States Department of the Treasury of Specifically Designated Nationals (SDN) and the dissemination list of the Non-Cooperative Countries and Territories and countries that are subject to the Financial Action Task Force's public statements.

The TRA conducted two training sessions for banks and three training sessions for the licenced foreign exchange dealers to improve their understanding of the anti-money laundering requirements. Quarterly meetings with the banks and licenced foreign exchange dealers were also conducted to enhance compliance with AML requirements. The TRA is working on implementing the requirements of the legislative amendments with assistance from the APG donors.

Financial Inclusion

The Reserve Bank, in partnership with the UNDP's Pacific Financial Inclusion Program (PFIP), hosted an Informal Information Exchange on Mobile Money on 20 September 2010. This was mainly to educate and build the awareness of the public and relevant stakeholders on the operations of mobile money and how it might be best used to increase access to appropriate financial services. This featured a product demonstration by Digicel given the proposed launch of its new mobile money product later in the year.

In September 2010, the Reserve Bank supported the launching of Digicel's mobile money product. This new product promotes greater financial inclusion and facilitates new services for payments for goods and services. In May 2011, the Reserve Bank endorsed the joint mobile banking agency arrangement between Digicel and Tonga Development Bank. The Reserve Bank in July 2011 registered Digicel as a foreign exchange dealer to provide financial services to their customers using mobile phones. These financial services were restricted to inward remittances and local disbursement only.

Operations of the Reserve Bank

Currency Operations

Notes in Circulation

During the year, the Reserve Bank continued to inspect, analyse and sort currency notes to meet the public demand for currency, and ensure that the quality of notes and coins on issue to the public are maintained at a high standard. At the end of June 2011, the face value of currency notes on issue, both new and reissuable, totaled $32.7 million compared to $31.2m of June 2010. This was an increase of 5 percent compared to the 18 percent increase between June 2009 and June 2010. Although the total value of currency notes in circulation increased year by year, the rate of increase has declined dramatically, reflecting a fall in public demand for cash. This is in line with the weak economic condition of the country.

During the year, the Reserve Bank issued $61 million (2010: $59 million) currency notes to the economy and received $58 million (2010: $54 million) as deposits from commercial banks. Out of these deposits, $7.9 million (2010: $11.4 million) were classified by the Reserve Bank as unfit for reissue and were destroyed. The currency notes of the Kingdom are printed by De La Rue Currency in the United Kingdom.

Coins in Circulation

At the end of June 2011, the face value of coins on issue totaled $1.83 million, compared to $1.76 million of the previous year. During the year, coins to a face value of $0.09 million were issued for circulation while a total of $0.003 million worth of coins were returned by banks. During the year, the Bank ordered new 20 seniti and 50 seniti coins from Royal Australian Mint to cater for public demand.

Note Trust Depots

The Reserve Bank has Note Trust Depot (NTD) agreements with all the commercial banks. These agreements provide the commercial banks with a facility to accommodate for their cash requirements and avoid calling on the NRBT vault all the time. However, during 2010/11, there was a decrease in commercial banks' usage of NTDs as banks became more risk averse and limited the amount of cash that they maintained in their premises. The commercial banks lodged a total of $13.3 million (2010: $17.6 million) and withdrew $11.6 million (2010: $18.1 million) from the NTDs. Compared to the previous year, the use of NTDs for deposits decreased by 24 percent while the use of NTDs for withdrawals decreased by 36 percent. This decline has increased the use of NRBT vault for deposit by 23 percent and for withdrawals by 19 percent. The Bank conducted a surprise check of these NTDs during the year and all were in order.

Counterfeit Notes

During the year, 1 counterfeit note was reported to the Reserve Bank compared to the 3 cases in the previous year. This was a $50 pa'anga note. This counterfeit note was reported by one of the commercial banks, and was part of the counterfeit notes created by the two foreigners who were apprehended by the police in May 2008. The Reserve Bank will continue issuing public brochures on identifying counterfeit notes both in the English and Tongan language.

Numismatic Coins and Notes

During the year, the Reserve Bank continued to receive royalty from the sale of numismatic coins to collectors throughout the world under agreements between the Reserve Bank and various producers for the production and marketing of coins of various denominations. There were no new agreements signed during the year. At the same time, the Reserve Bank continued to sell numismatic coins and notes to overseas collectors.

The total revenue collected from numismatic coins and notes was $0.09 million, an increase of 50 percent from 2009/2010. The increase in revenue was attributed mainly to the Reserve Bank sale of numismatic coins and notes to overseas collectors.

Currency Technical Assistance

During the year, the Bank engaged a central bank expert on currency management to provide a high level review of the currency operations as well as review the framework for forecasting of public demand for currency in Tonga. The Bank has commenced preliminary work on implementing the recommendations from this review. The Bank also commissioned an independent quality review of the new designed currency notes against the specifications agreed to with the currency notes supplier, De La Rue of the United Kingdom. The outcome of the quality review of the new design currency notes confirmed that the production of the new designed currency notes aligned with the agreed specifications.

Financial Performance

Gross income from operations for the year ended 30 June 2011 amounted to $7.348 million (2010: $5.269 million). The 39 percent increase in the Reserve Bank's gross income in 2010/11 was mainly due to higher interest earned from investments of higher than expected level of foreign reserves. Income on sales and purchases of foreign currencies also increased due to the higher value and volume of foreign exchange transactions.

Interest expense, currency, administration and other costs totaled $4.929 million (2010: $3.970 million), an increase of 24 percent from the previous year. This was mainly due to higher monetary policy costs as banks' exchange settlement accounts were higher than expected. Operational costs for short-term technical assistance and staff costs were also higher due to the engaging of necessary technical experts and the recruitment of staff to carry out the Bank's statutory functions. Maintenance costs and expenditure on goods and services were higher than previous years mainly reflecting the impact of higher inflation on the prices of goods and services purchased. The cost of issuing currency also increased as the Bank continued to maintain better quality of notes in circulation throughout the financial year. The combination of the above movements resulted in a $2.418 million (2010: $1.299 million) of net operating profit for the year, a significant increase of 86 percent from the previous year.

In accordance with section 8(1)(c) of the NRBT (Amendment) Act 2007, 12 percent ($307,073) of the Net Profit is to be transferred to the Bank's General Reserves, and the remainder ($2,111,513) is payable to Government.The Board of Trustees of the National Reserve Bank of Tonga Staff Provident Fund continued to manage the staffs' provident fund scheme and their accounts.

Information Systems and Technology

During the year, the Reserve Bank continued its efforts to comply with the outcome of the IT Audit in 2009. The main achievements included the formalization of the Reserve Bank's IT Policies which was approved by the Board in March 2011 and the change of the Bank's network topology from being work grouped to a central domain network. The Bank engaged an expert to conduct a post IT Audit implementation review of the network setup which was completed in April, 2011. The result of this review prompted further work required to ensure that the network topology was fully secured. The IT department also completed the IT Risk Framework and IT Strategic Plan as required by the IT Audit review and purchased a performance monitoring tool kit to assist the department's ability to monitor the IT system's performance and for reporting to management of these performances.

The Reserve Bank continued to improve its business continuity plans by establishing a backup server of the digital recording system that records the security camera images.

To provide timely dissemination of information and to minimize duplication of works, the Bank improved and developed the Financial Institutions and Markets, Administration, Human Resource and Research Departments management information database.

The Reserve Bank continued to update the Bank's website with authorized statistics and press releases and monitored the number of users visiting the website.

General Administration

In addition to the normal services of administration of the Reserve Bank, the Administration Department strengthened the internal controls for commitment and inventory processes. These measures had enabled weekly reconciliation of the commitment between Administration and Accounts to determine the expenditure and budget status on a timely manner. In addition, these measures enhanced the monthly reconciliation of stationery stock and the quarterly stock take of fixed asset by the departments to verify fixed asset status. Quality assurance checks continued to be conducted on the physical and electronic filing of Bank documents.

Other achievements during the year included preliminary work on the review of the air condition system of the Bank. The Administration department played a major role in the coordination of the emergency working group of the Bank to make swift decisions in response to 3 natural disaster evacuations during the year.

The Administration Department played a vital role in the awareness and distribution of the 2011 MoneyPacific Calendars of the MoneyPacific Working Group of which Governors of the South Pacific Central Banks strongly support. The calendar is part of the MoneyPacific Working Group's effort to improve financial literacy and awareness.

Human Resources

The Human Resource (HR) Unit continued to manage human resource related policies and procedures of the Bank. It recruited staff to fill vacancies and at the end of the year, the Reserve Bank staff increased by 9 to 79 staff compared to 70 staff, in the previous year. The Bank recruited 13 staff during the year and processed 9 staff resignations. The Staff resignations were mainly for personal reasons, migration and to pursue further studies overseas. An important achievement for the Bank was when four promotions were approved by the Board with Ms. Jessie Cocker appointed under a contract to the position of Deputy Governor, ‘Ungatea Latu appointed to Manager Financial Institutions and Markets, ‘Anapuli Matoto appointed as Manager Research and Ma'ata ‘Aho appointed as the Assistant Manager, Accounts and Currency. These appointments have strengthened the management team of the Bank.

The annual review of the NRBT Staff Terms and Condition of Service and the Personal Loan Scheme was completed in June 2011 and the Bank began its preparation to comply with the requirements of the new MLCI Personal Property Securities Act registry system.

In addition to the normal services of human resource of the Reserve Bank, the HR Unit continued to secure with insurance brokers the annual renewal of the Bank's insurance policies for Staff Term Life, Medical Scheme, staff housing and motor vehicles, Travel Insurance, NRBT building and contents and NRBT motor vehicles. Furthermore, the HR team continued to emphasize the importance of staff health by providing services to monitor staff weight and blood pressure on a monthly basis and providing zumba aerobics at the Reserve Bank grounds for the staff at least twice a week. The Reserve Bank participated in a survey by the Ministry of Health and the result reflected that 1 percent of staff had serious health problems requiring close monitoring.

Training & Development

The Human Resource Unit is also responsible for the management and monitoring of the staff training needs analysis of the Bank. The Reserve Bank continued to invest in the training of its Human Resource, through overseas training, local training and in-house training programs. The overseas training programs included the Bank of Papua New Guinea onsite visit to Westpac PNG, Strategic Implementation Plan Training, Asian Regional Public Debt Management Forum, and the New Manager's Course.

Local trainings for staff at the Reserve Bank included the Customer Service Training by the S&K Performance Solutions (Tonga), First Aid Refresher course by Tonga Red Cross, Anger Management and Adaptive Mentor workshop hosted by the University of the South Pacific, 'Atele, Data Analysis and Report Writing course hosted by the Statistics Department, a Public forum on personal property securities (PSSA online) and basic plumbing workshop hosted by the MLCI, and Pacific Cybercrime Legislation workshop hosted by the Ministry of Information and Communications. The Reserve Bank co-hosted with PFTAC and Bank of England the Centre for Central Banking Studies workshop (CCBS) here in Tonga in August 2010 specifically on exchange rates, foreign reserves management and financial stability.

CCBS workshop co-hosted by NRBT, PFTAC and Bank of England

The Reserve Bank provided quarterly computer training to strengthen the Staff skills on statistical formulas, advanced macros, and to enhance the application of Adobe PageMaker for the compilation of the Bank's annual report. Furthermore, the Reserve Bank provided inter-departmental trainings mainly to ensure that there are enough backups within the teams to minimize disruption to the operation of the Bank. The Reserve Bank continued to support staff development through financial assistance to those undertaking approved part time and correspondence courses in accordance with the Bank's Training Policy. This included distance flexible learning courses to Pennfoster, USA in the areas of electricity for 1 Building Staff, economic, accounting and management courses with the University of New England, Australia and the University of the South Pacific (USP) for 3 Research Staff, and 1 Settlement Staff, CISCO courses on CISCO Certified Network Associate (CCNA) for 1 IT Staff at Tupou Tertiary Institute, and 1 Human Resource staff to undertake a course with the National Centre for Vocational Studies (NCVS). The Government Scholarship Committee had offered one of the NZAid scholarships to the Reserve Bank in August, 2010 and further selected a suitable candidate to pursue in January 2011 to do a bachelor degree in Commerce at the University of Victoria, NZ.

During the year, the Reserve Bank continued to receive advisory and technical services provided by the IMF, ADB/PEM, AusAID, the PFTAC, APG, Royal Australian Mint, Otis Ltd (NZ), Pricewaterhouse Cooper Ltd (PWC) Fiji, Jaimi Associates Ltd (Tonga), Reserve Bank of Fiji, Reserve Bank of Australia and the Reserve Bank of New Zealand. These advisory and technical services were mainly in the areas of monetary policy framework and coordination between the government, the central bank and other key stakeholders, banking supervision, exchange rate regime, exchange control return of export proceeds, currency and numismatic coins operations, anti-money laundering, information technology and property plant and equipment.

Attendance at Meetings

In July 2010, the Governor and the Manager, Financial Institutions and Markets attended the APG Annual meeting held at Singapore. In September, 2010, the Deputy Governor attended the PFTAC Tripartite Review held at Vanuatu. The Governor and the Assistant Manager, Accounts and Currency attended the Royal Australia Mint Conference in Canberra Australia. In October 2010, the Governor and the Manager of Research attended the World Bank/IMF Annual meeting held in Washington, DC whilst the Manager, Financial Institutions and Markets attended the AFSPC meeting held in Fiji. In December 2010, the Governor and Manager, Financial Institutions and Markets attended the South Pacific Central Bank Governors' Annual Meeting held at Wellington, NZ. In May, 2011, the Governor attended the MoneyPacific Working Group Meeting held at Auckland, NZ.

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, tenants, board of directors, VIP personnel and the Bank's premises were maintained at all times and the Governor's residence upon request. Major achievements during the year included the installation and training on how to effectively operate the new door access system and the upgraded security cameras and recording system. In addition, the Guard's standing orders and policies were reviewed and implemented to strengthen the security operation of the Bank and to be in line with international standards. The renovation of the guard house was completed to improve safety and enhance the monitoring of access to the Bank premises. The security unit played a vital part in assisting the NRBT emergency working group to conduct the evacuation processes during the tsunami and cyclone warnings over the year. The security unit continued to assist the building team with ensuring the security and safety of the operations of the building, plant and equipment. The recruitment of six guards including the Assistant Guard Commander helped to strengthen the unit's performance and replaced five guards that resigned during the year.

Building, Plants and Equipment

The Building Team continued to ensure that appropriate and timely maintenance services were conducted to the Bank's property plant and equipment during the year to ensure the safety and security of the premises for the operation of the Bank and its Tenants. The major achievements were the completion of the installation of the new lift, the installation of the new Cardax Door Access system, the renovation of the guard house and server room, and the installation of a new water tank. The Building Team also worked together with the Administration team on the commencement of the review of the air condition system of the Bank. Furthermore, the Building Team supervised and assisted contracted maintenance works with Technicians onsite from Chubb NZ, Otis NZ, Fletcher Tonga, ITL (Tonga), South Pacific Safe & Security Ltd NZ, Jackson Electrics NZ, and Delarue (UK) and Australia.

In August 2010, a building survey was completed by Jaimi Associates, and the results assisted with the review of the Bank's rental rates. In May, 2011, the Board of Directors approved the revised rental rate to be effective from 1st July, 2011.

The Building Team is also a vital part of the NRBT emergency working group in conducting the evacuation processes during the tsunami and cyclone warnings over the year.

External Relations

During the year, the Reserve Bank continued to prepare reports for the Minister of Finance and Government and attended meetings with the Minister of Finance when required. In May 2011 the Reserve Bank commenced a monthly meeting with the Minister of Finance to discuss issues of mutual interest. In September 2010, the Reserve Bank was co-opted by the Parliament Select Committee on Financial Matters to discuss some of the Bank's policies mainly in regards to interest rate policy. During the year, the Bank presented on the economic and financial conditions of the country to stakeholders such as the chambers of commerce, USP economic conference, Association of Banks in Tonga, New Zealand High Commissioner and the Australian High Commissioner. The Bank made a special presentation to brief the new Minister of Finance in January 2011 and presented for the first time to Cabinet in May 2011 on the Bank's March 2011 Monetary Policy Statement. The Reserve Bank continued to release its quarterly bulletins during the year. The Bank submitted its operations report with the audited financial statements of the Bank for the year ended June 2010 before the end of September 2010 and published its Monetary Policy Statements for September 2010 and March 2011 as required by the NRBT Act. These reports and related information and press releases on these subjects were posted to the Bank's website. The Reserve Bank conducted regular meetings with the domestic banks in order to review activities in the banking sector as well as to discuss policy issues. The Reserve Bank continued to prepare and hosted the IMF during the IMF Article IV consultation visit in March 2011 and also met with representatives of international aid agencies and bilateral aid donors to discuss matters of mutual interest. The Reserve Bank continued to provide assistance to the government through the macroeconomic policy committee and the weekly cashflow meetings.

Senior Officers during the year ended 30 June 2011

Governor	Siosi C. Mafi
Deputy Governor	Jessie Cocker
Manager, Accounts & Currency	Lata Tangimana
Manager Information System & Technology and Administration	Elizabeth Baker
Manager, Financial Institutions & Markets	‘Ungatea Latu
Manager, Research Department	‘Anapuli Matoto
Assistant Manager, Financial Markets	‘Isapela Hufanga
Assistant Manager, Accounts & Currency	Ma’ata Mone ‘Aho
Guard Commander	Semisi Fifita

National Reserve Bank of Tonga

Financial Statements
Year Ended 30 June 2011

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NATIONAL RESERVE BANK OF TONGA **FINANCIAL STATEMENTS 30 JUNE 2011**

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 2011, and the related Statements of Comprehensive Income, Distribution, Changes in Equity and Cash Flows 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:

Mr Steve Edwards (appointed 16th February 2011)
HRH Princess Salote Pilolevu Tuita
Mr Richard Prema
Mrs Siosi C Mafi
Mr ‘Aisake Eke (resigned 21st October 2010)
Mr Tiofilusi Tiueti (appointed 21st October 2010)

2. PRINCIPAL ACTIVITIES

The National Reserve Bank of Tonga's (the Bank) principal objectives as a central bank, as defined in Section 4 of the National Reserve Bank of Tonga (NRBT) (Amendment) Act 2007, shall be, to -

a) maintain internal and external monetary stability; and
b) promote a sound and efficient financial system

The principal functions of the Bank shall be, to -

a) issue currency;
b) formulate and implement monetary policy;
c) regulate as required the supply, availability and international exchange of money;
d) hold and manage the external reserves of the Kingdom;
e) provide advisory services to the Minister on banking and monetary matters;
f) be the principal banker, fiscal agent and depository of the Government;
g) undertake banking business, in Tonga or elsewhere;
h) regulate and supervise financial institutions; and
i) oversee and promote the efficient, sound and safe functioning of the payment system.

3. TRADING RESULTS

The operating profit of the Bank for the year ended 30 June 2011 was $2,418,586 (2010: $1,299,146).

4. GENERAL RESERVES

In accordance with Section 8(1)(c) of the National Reserve Bank of Tonga (Amendment) Act, 2007, the Minister and the Board of Directors have agreed to transfer $307,073 (2010: $324,787) to the General Reserve at year end.

5. PAYABLE TO GOVERNMENT

In accordance with Section 8(3) of the National Reserve Bank of Tonga (Amendment) Act, 2007, subject to Section 8(1) and Section 8(2), the amount of $2,111,513 (2010: $974,359) is payable to the Government of the Kingdom of Tonga.

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.

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 15th day of September, 2011.

Mr Steve Edwards
CHAIRPERSON

Mrs Siosi C Mafi
GOVERNOR

STATEMENT BY DIRECTORS

In the opinion of the Directors:

(a) 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 2011,

(b) the accompanying statement of comprehensive income is drawn up so as to give a true and fair view of the results of the Bank for the year ended 30 June 2011,

(c) the accompanying statement of distribution is drawn up so as to give a true and fair view of the distribution of operating profit of the Bank for the year ended 30 June 2011,

(d) 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 2011, and

(e) the accompanying statement of cash flows 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 2011.

For and on behalf of the Board of Directors by authority of a resolution of the Directors this 15th day of September, 2011.

Mr Steve Edwards
CHAIRPERSON

Mrs Siosi C Mafi
GOVERNOR

INDEPENDENT AUDIT REPORT

To the Shareholder of the National Reserve Bank of Tonga

Scope

We have audited the accompanying financial statements of the National Reserve Bank of Tonga (the Bank).The financial statements comprise the balance sheet of the Bank as at 30 June 2011 and the statement of comprehensive income, distribution, changes in equity and cash flows for the year then ended and a summary of significant accounting policies and other explanatory notes as set out on pages 36 to 59.

Directors' and Management's Responsibility for the Financial Statements

Directors and Management are responsible for the preparation and fair presentation of these financial statements in accordance with the basis of accounting described in note 2 of the financial statements and in the manner required by the National Reserve Bank of Tonga Act, 1988, and the National Reserve Bank of Tonga (Amendment) Act, 2007. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

This report is made solely to the Bank's shareholder. Our audit work has been undertaken so that we might state to the Bank's shareholder those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Bank and the Bank's shareholder, for our audit work, for this report, or for the opinions we have formed. Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by directors and management, as well as evaluating the overall presentation of the financial statements.

INDEPENDENT AUDIT REPORT (continued)

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the accompanying financial statements have been prepared, in all material respects, in accordance with the basis of preparation and the accounting policies described in note 2 of the financial statements and in the manner required by the National Reserve Bank of Tonga Act, 1988, and the National Reserve Bank of Tonga (Amendment) Act, 2007.

Without qualifying our opinion, we emphasise that the accounting policies used and disclosures made are not intended to, and do not, comply with certain requirements of International Financial Reporting Standards.

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PricewaterhouseCoopers

15 September 2011
Suva, Fiji

PricewaterhouseCoopers
Charted Accountants

NATIONAL RESERVE BANK OF TONGA

BALANCE SHEET
AS AT 30 JUNE 2011

	Notes	2011	2010
ASSETS		**$**	**$**
Foreign Currency Assets			
Short Term Investments and Current Accounts	8	180,072,472	145,224,089
Accrued Interest		2,171,319	1,343,408
International Monetary Fund (IMF)	9		
- Reserve Tranche Position		4,611,080	4,918,486
- Special Drawing Rights		19,075,162	20,327,609
Local Currency Assets			
Cash on Hand	18	2,092,242	115,083
Accrued Interest		10,694	12,034
Other Assets	10	3,376,984	3,786,430
International Monetary Fund - Currency Subscription	9	14,655,548	15,239,788
Property, Plant and Equipment	11	8,906,855	8,643,788
Total Assets		**234,972,356**	**199,610,715**
LIABILITIES			
Foreign Currency Liabilities			
Accrued Interest		13,629	7,900
Demand Deposits	12(a)	4,038,733	10,407,305
IMF Special Drawing Rights Allocation	9	17,728,521	18,910,422
Local Currency Liabilities			
Payable to Government	13	2,111,513	974,359
Demand Deposits	12(b)	126,211,869	86,395,678
Accrued Interest		166,286	118,993
Other Liabilities	16	4,159,805	683,067
Currency in Circulation	14	34,525,489	32,924,309
Statutory Reserve Deposits	15	15,884,000	14,793,000
International Monetary Fund - Currency Subscription	9	14,655,548	15,239,788
Employee Provisions	17	115,330	92,535
Total Liabilities		**219,610,723**	**180,547,356**
NET ASSETS		**$15,361,633**	**19,063,359**
CAPITAL AND RESERVES			
Authorised Capital		5,000,000	5,000,000
Paid up Capital		5,000,000	5,000,000
General Reserves		10,000,000	9,692,927
Revaluation Reserve Account		361,633	4,370,432
TOTAL CAPITAL AND RESERVES		**$15,361,633**	**$19,063,359**

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

NATIONAL RESERVE BANK OF TONGA

STATEMENT OF COMPREHENSIVE INCOME YEAR ENDED 30 JUNE 2011

Income	**Notes**	**2011**	**2010**
		$	**$**
Interest income	4	4,531,919	3,526,890
Other income	5	2,816,537	1,742,987
Total Operating Income		**7,348,456**	**5,269,877**
Expenses			
Interest expense	6	715,217	294,059
Administration and other expenses	7	4,214,653	3,676,672
Total Operating Expenses		**4,929,870**	**3,970,731**
Net profit available for distribution		**2,418,586**	**1,299,146**
Net gains/(losses) arising from the translation of foreign currency balances to local currency		(4,008,799)	539,686
Other comprehensive income for the period		**(4,008,799)**	**539,686**
Total comprehensive income		**(1,590,213)**	**$ 1,838,832**

The above statement of comprehensive incomes should be read in conjunction with the accompanying notes.

NATIONAL RESERVE BANK OF TONGA

STATEMENT OF DISTRIBUTION
YEAR ENDED 30 JUNE 2011

	Notes	2011	2010
Net profit available for distribution		**$2,418,586**	**$1,299,146**
Distribution as follows: Transfer to General Reserves as required under:	2(m)		
• Section 8(1)(c) of the National Reserve Bank of Tonga (Amendment) Act, 2007		307,073	324,787
Balance Payable to Government of Tonga as required under Section 8(3) of the National Reserve Bank of Tonga (Amendment) Act, 2007	13	2,111,513	974,359
		$2,418,586	**$1,299,146**

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

NATIONAL RESERVE BANK OF TONGA

STATEMENT OF CHANGES IN EQUITY YEAR ENDED 30 JUNE 2011

	Paid up Capital $	General Reserves $	Revaluation Reserve Account $	Total $
Balance 30 June 2009	**$5,000,000**	**$9,368,140**	**$3,830,746**	**$18,198,886**
Net gains arising during the year from translation of foreign currencies to Tongan currency	-	-	539,686	539,686
Transfer to General Reserves (as provided for under Section 8(1)(c) of the National Reserve Bank of Tonga (Amendment) Act, 2007, and approved by the Minister of Finance	-	324,787	-	324,787
Balance 30 June 2010	**$5,000,000**	**$9,692,927**	**$4,370,432**	**$19,063,359**
Net losses arising during the year from translation of foreign currencies to Tongan currency	-	-	(4,008,799)	(4,008,799)
Transfer to General Reserves (as provided for under Section 8(1)(c) of the National Reserve Bank of Tonga (Amendment) Act, 2007, and approved by the Minister of Finance	-	307,073	-	307,073
Balance 30 June 2011	**$5,000,000**	**$10,000,000**	**$361,633**	**$15,361,633**

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 2011

	Note	2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES		$	$
Rental income		1,054,700	838,864
Numismatic sales		85,743	55,385
Other income		1,746,466	827,620
Interest received		3,705,347	3,596,313
Purchase of currency		(564,632)	(16,421)
Interest paid		(662,196)	(196,276)
Administrative expenses		(2,513,162)	(2,859,508)
Net cash inflow from operating activities		**2,852,266**	**2,245,977**
CASH FLOWS FROM INVESTING ACTIVITIES			
Purchase of fixed assets		(613,466)	(871,568)
Net movement in IMF accounts		1,559,853	(18,390,113)
Net movement in staff loans		34,919	(18,209)
Net cash inflow/(outflow) from investing activities		**981,306**	**(19,279,890)**
CASH FLOWS FROM FINANCING ACTIVITIES			
Net movement in currency in circulation		1,601,180	4,748,909
Net movement in demand deposits		31,319,569	43,510,496
Net movement in statutory deposits		1,091,000	(14,677,000)
Net movement in Government of Tonga accounts		(28,209)	(1,279,240)
Net movement in funds held for clearance		3,017,229	5,993
Net cash inflow from financing activities		**37,000,769**	**32,309,158**
Net effect of change in exchange rates		**(4,008,799)**	**539,686**
NET INCREASE IN CASH		**36,825,542**	**15,814,931**
CASH AT BEGINNING OF FINANCIAL YEAR		**145,339,172**	**129,524,241**
CASH AT END OF FINANCIAL YEAR	**18**	**$182,164,714**	**$145,339,172**

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 2011

1. GENERAL INFORMATION

The National Reserve Bank of Tonga's principal objectives as a central bank, as defined in Section 4 of the NRBT (Amendment) Act 2007, shall be, to -

a) maintain internal and external monetary stability; and
b) promote a sound and efficient financial system.

The principal functions of the Bank shall be, to -
a) issue currency;
b) formulate and implement monetary policy;
c) regulate as required the supply, availability and international exchange of money;
d) hold and manage the external reserves of the Kingdom;
e) provide advisory services to the Minister on banking and monetary matters;
f) be the principal banker, fiscal agent and depository of the Government;
g) undertake banking business, in Tonga or elsewhere;
h) regulate and supervise financial institutions; and
i) oversee and promote the efficient, sound and safe functioning of the payment system.

These financial statements have been approved for issue by the Board of Directors on 15th September 2011.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND STATUTORY REQUIREMENTS

(a) Basis of accounting

The financial statements of the Bank have been prepared in accordance with the National Reserve Bank of Tonga Act, 1988 and the National Reserve Bank of Tonga (Amendment) Act, 2007. The Bank's accounting policies are based on International Financial Reporting Standards ("IFRS") except where the Act requires a different treatment, as noted in Note 2 (b), in which the Act takes precedence.

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.

Standards and interpretations issued but not yet effective

The following standards and interpretations have been issued and are mandatory for the company's accounting periods beginning on or after 1 July 2011 or later periods. Adoption of these standards and interpretations will not have any significant impact on the Bank's financial statements.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND STATUTORY REQUIREMENTS - Continued

Standard/ Interpretation	Content	Applicable for financial years beginning on/after
IFRS 1 Amendment	First-time adoption: Exemption for hyperinflation and removal of fixed dates	1 July 2011
IFRS 7 Amendment	Financial instruments: Disclosures on transfer of financial assets	1 July 2011
IAS 12 Amendment	Income taxes: Defferred taxes	1 January 2012
IAS 1 Amendment	Financial statement presentation regarding other comprehensive income	1 July 2012
IAS 19 Amendment	Employee benefits	1 January 2013
IAS 27 Amendment	Separate financial statements	1 January 2013
IAS 28 Amendment	Associates and joint ventures	1 January 2013
IFRS 9 Amendment	Financial instruments: Classification and measurement	1 January 2013
IFRS 10 Amendment	Consolidated financial statements	1 January 2013
IFRS 11 Amendment	Joint arrangements	1 January 2013
IFRS 12 Amendment	Disclosures of interests in other entities	1 January 2013
IFRS 13 Amendment	Fair value measurement	1 January 2013

(b) Foreign currencies

Foreign currencies have been translated to Tongan currency at rates of exchange ruling at year end.

Exchange 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, the NRBT (Amendment) Act, 2007 and the Miscellaneous Amendments (Privy Council) Act 2010, and are not included in the computation of annual profits and losses of the Bank as required under International Accounting Standard 21, “The effects of changes in foreign exchange rates” (IAS 21). The impact of this in the statement of comprehensive income would be a reduction in net profit by $4,008,799 (2010: increase of $539,686).

Net 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, Cabinet 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.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND STATUTORY REQUIREMENTS - Continued

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. According to the National Reserve Bank of Tonga (Amendment) Act 2007, any balance remaining in the Revaluation Reserves Account shall be carried forward to the next financial year.

(c) Financial Assets and Liabilities

Investment Securities

The Bank only invests in securities with the intention to hold to maturity. The 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 Bank.

Other Financial Assets and Liabilities

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

(d) 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.

(e) 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 and the Miscellaneous Amendments (Privy Council) Act 2010, Cabinet 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.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND STATUTORY REQUIREMENTS - Continued

(f) Income tax

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

(g) 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 and buildings	1.01 -2%
Computer and office equipment	25.0%
Furniture and fittings	25.0%
Motor vehicles	25.0%

(h) Employee Entitlements

The Bank and staff make contributions to a staff provident scheme based on the years of service.

Liabilities for other employee entitlements which are not expected to be paid or settled within twelve months of the reporting date are accrued in respect of all employees at the present value of future amounts expected to be paid.

(i) 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, current accounts and short term deposits.

(j) Revenue Recognition

Interest income is brought to account on an accrual basis.

(k) Staff Loans

Loans are carried in the balance sheet at historical cost net of impairment provisions. A provision for impairment is based on an appraisal carried out at the end of the financial year. The amounts of potential losses that have been identified are either written off against provisions in the year in which they are recognised or recognised as an expense in the income statement.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND STATUTORY REQUIREMENTS - Continued

(l) 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.

(m) General Reserve and Distribution of Profits

- Section 8(1) of the National Reserve Bank of Tonga (Amendment) 2007 states that:
  a) where the General Reserve does not exceed 50% of the authorised capital of the Bank, 100% of the net profit be transferred to the General Reserve;
  b) where the General Reserve exceeds 50 percent of the authorised capital of the Bank, 50 percent until the General Reserve is equal to the authorised capital of the Bank; and
  c) where the General Reserve exceeds 100 percent but does not exceed 200 percent of the authorised capital of the Bank, 25 percent or such lesser sum to increase the General Reserve to twice the authorised capital of the Bank; Provided that upon agreement between the Minister and the Bank, the General Reserve may be increased.
- Section 8(2) states that subject to Section 8(1), the remainder of the net profits for the financial year shall be applied to the redemption of any securities issued under Section 6 held by the Bank.
- Section 8(3) states that the balance of the net profit for the financial year remaining after all deductions as above be paid to the Government of the Kingdom of Tonga.

(n) Revaluation Reserve

Unrealised exchange gains and losses arising from revaluation of foreign currencies are transferred to the Revaluation Reserve (refer Note 2(b)) and are not included in the computation of annual profits and losses of the Bank.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND STATUTORY REQUIREMENTS - Continued

(o) Segment Reporting

The Bank presents 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.

(p) Leases

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

(q) Currency of Presentation

All amounts are expressed in Tongan Pa'anga.

3. FINANCIAL RISK MANAGEMENT

The majority of the Bank's financial risks arise from the foreign reserves management unit of the Bank's Financial Markets Department. The main financial risks to which the Bank is exposed include liquidity risk, credit risk and market risks and policies for managing these risks are outlined below.

3. FINANCIAL RISK MANAGEMENT - continued

(a) Credit Risk

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 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 Bank may deal with in foreign exchange must have minimum credit ratings of A.

The NRBT uses Standard & Poor's credit ratings of assessing the credit risk of foreign counterparties. The credit ratings of counterparties are on "watch"

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

	2011 $	2010 $
Foreign currency assets		
Short Term Commercial Paper and current accounts	180,072,472	145,224,089
Total financial investments	**$180,072,472**	**$145,224,089**

The Bank's end of year concentration of credit exposure, based on the country in which the counterparty is located, is as follows:

	2011 $	2010 $
Australia	126,894,292	121,344,323
New Zealand	16,783,051	11,410,975
United States of America	24,132,273	11,056,785
Switzerland	12,130,984	1,092,588
United Kingdom	91,872	229,369
Fiji	40,000	90,049
Total financial investments	**$180,072,472**	**$145,224,089**

3. FINANCIAL RISK MANAGEMENT - continued

(b) Liquidity Risk

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 Bank's foreign currency assets.

To minimize 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 balances of the investible reserves are placed on term investments of up to 12 months. The composition of foreign currency assets is monitored daily. The Bank manages liquidity on a contractual maturity basis, which is consistent with the expected maturities of financial instruments.

3. FINANCIAL RISK MANAGEMENT - continued

(b) Liquidity Risk – continued

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

Maturity Analysis as at 30 June 2011

	0-3 months	3-12 months	1- 5 years	Over 5 Years	No Specific maturity	Total
Liabilities						
Foreign Currency Liabilities						
Demand Deposits	4,038,733	-	-	-	-	4,038,733
IMF Special Drawing Rights Allocation	-	-	-	-	17,728,521	17,728,521
Accrued Interest	13,629	-	-	-	-	13,629
Local Currency Liabilities						
Payable to Government	2,111,513	-	-	-	-	2,111,513
Demand Deposits	126,211,869	-	-	-	-	126,211,869
Accrued Interest	166,286	-	-	-	-	166,286
Other Liabilities	3,426,761	77,867	-	-	655,177	4,159,805
Currency in Circulation	-	-	-	-	34,525,489	34,525,489
Statutory Reserve Deposits	-	-	-	-	15,884,000	15,884,000
International Monetary Fund - Currency Subscription	-	-	-	-	14,655,548	14,655,548
Employee Provisions	93,613	2,947	9,720	9,050	-	115,330
Total Liabilities (contractual maturity dates)	**136,062,404**	**80,814**	**9,720**	**9,050**	**83,448,735**	**219,610,723**

Maturity Analysis as at 30 June 2010

	0-3 months	3-12 months	1- 5 years	Over 5 Years	No Specific maturity	Total
Liabilities						
Foreign Currency Liabilities						
Demand Deposits	10,407,305	-	-	-	-	10,407,305
IMF Special Drawing Rights Allocation	-	-	-	-	18,910,422	18,910,422
Accrued Interest	7,900	-	-	-	-	7,900
Local Currency Liabilities						
Payable to Government	974,359	-	-	-	-	974,359
Demand Deposits	86,395,678	-	-	-	-	86,395,678
Accrued Interest	118,993	-	-	-	-	118,993
Other Liabilities	266,886	-	-	-	416,181	683,067
Currency in Circulation	-	-	-	-	32,924,309	32,924,309
Statutory Reserve Deposits	-	-	-	-	14,793,000	14,793,000
International Monetary Fund - Currency Subscription	-	-	-	-	15,239,788	15,239,788
Employee Provisions	76,409	1,342	7,025	7,759	-	92,535
Total Liabilities (contractual maturity dates)	**98,247,530**	**1,342**	**7,025**	**7,759**	**82,283,700**	**180,547,356**

3. FINANCIAL RISK MANAGEMENT - continued

(c) Market Risk

Market risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market prices. In respect of the Bank, market risk comprises interest rate risk and foreign currency risk.

(i) Interest rate risk

Interest rate risk refers to the risk of loss arising from changes in interest rates. The Bank limits interest rate risk by modified duration targets. The benchmark modified duration for the total portfolio is capped at 36 months. The duration of the portfolio is re-balanced regularly to maintain the target duration.

(ii) Foreign exchange risk

Exchange rate risk relates to the risk of loss arising from changes in the exchange rates against the Tongan Pa'anga. The 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 Bank's foreign currency assets.

The following tables show the currency concentration of the Bank's assets and liabilities as at 30 June 2011 and 2010 in Tongan Pa'anga equivalents.

At 30 June 2011	USD	EUR	AUD	GBP	NZD	Other	Total
ASSETS							
Short Term Investments and Current Accounts	76,673,114	1,848,568	72,038,231	96,907	29,375,652	40,000	180,072,472
Accrued Interest	252,460	1,274	1,449,309	2	450,731	17,543	2,171,319
International Monetary Fund							
- Reserve Tranche Position	-	-	-	-	-	4,611,080	4,611,080
- Special Drawing Rights	-	-	-	-	-	19,075,162	19,075,162
Total Assets	**76,925,574**	**1,849,842**	**73,487,540**	**96,909**	**29,826,383**	**23,743,785**	**205,930,033**
LIABILITIES							
Demand deposits	3,867,009		171,724	-	-	-	4,038,733
Accrued Interest	-	-	-	-	-	13,629	13,629
IMF Special Drawing Rights Allocation	-	-	-	-	-	17,728,521	17,728,521
Total Liabilities	**3,867,009**	**-**	**171,724**	**-**	**-**	**17,742,150**	**21,780,883**
NET POSITION	**73,058,565**	**1,849,842**	**73,315,816**	**96,909**	**29,826,383**	**6,001,636**	**184,149,150**

3. FINANCIAL RISK MANAGEMENT - continued

a) Market Risk - continued

(ii) Foreign exchange risk - continued

At 30 June 2010	USD	EUR	AUD	GBP	NZD	Other	Total
ASSETS							
Short Term Investments and Current Accounts	63,160,596	713,610	51,693,910	234,814	29,331,110	90,049	145,224,089
Accrued Interest	143,955	24	781,565	1	407,702	10,161	1,343,408
International Monetary Fund							
- Reserve Tranche Position	-	-	-	-	-	4,918,486	4,918,486
- Special Drawing Rights	-	-	-	-	-	20,327,609	20,327,609
Total Assets	**63,304,551**	**713,634**	**52,475,475**	**234,815**	**29,738,812**	**25,346,305**	**171,813,592**
LIABILITIES							
Demand deposits	8,857,074	546,800	1,003,431	-	-	-	10,407,305
Accrued Interest	-	-	-	-	-	7,900	7,900
IMF Special Drawing Rights Allocation	-	-	-	-	-	18,910,422	18,910,422
Total Liabilities	**8,857,074**	**546,800**	**1,003,431**	**-**	**-**	**18,918,322**	**29,325,627**
NET POSITION	**54,447,477**	**166,834**	**51,472,044**	**234,815**	**29,738,812**	**6,427,983**	**142,487,965**

Sensitivity to Foreign Currency Risk

The sensitivity of the Bank's financial assets and liabilities to assumed across-the-board 5% movement of the Tongan Pa'anga against other foreign currencies at 30 June would have increased/ decreased equity by the amounts shown below:

	2011	**2010**
USD	3,652,928	2,722,374
EUR	92,492	8,342
AUD	3,665,791	2,573,602
GBP	4,845	11,741
NZD	1,491,319	1,486,941
FJD	2,000	4,502
SDR	298,082	316,897

4. INTEREST INCOME

	2011 $	**2010** $
Overseas investments	4,509,245	3,502,717
Staff Loans	22,674	24,173
	$4,531,919	**$3,526,890**

NATIONAL RESERVE BANK OF TONGA

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS YEAR ENDED 30 JUNE 2011

5. OTHER INCOME

	2011 $	2010 $
Numismatic Coins	85,743	55,385
Rental Income	903,155	859,984
Gain on sale of Assets	1,375	12,580
Forex sales/ purchases	1,707,286	774,087
Bank user fees	20,037	26,807
Information services – publications	35	45
Miscellaneous	98,906	14,099
	$2,816,537	**$1,742,987**

6. INTEREST EXPENSE

	2011 $	2010 $
Foreign Currency Accounts	82,455	54,337
Domestic Currency Accounts	632,762	239,722
	$715,217	**$294,059**

7. ADMINISTRATION AND OTHER EXPENSES

	2011 $	2010 $
Administration	1,429,483	1,086,945
Retirement fund	187,958	162,724
Staff Costs	1,392,896	1,284,487
Audit Fees	25,000	25,000
Currency Issue (refer note 10)	833,963	718,460
Depreciation	345,353	399,056
	$4,214,653	**$3,676,672**

8. SHORT TERM INVESTMENTS AND CURRENT ACCOUNTS

	2011 $	2010 $
Current Accounts	37,929,916	16,792,884
Short term Investments	142,142,556	128,431,205
	$180,072,472	**$145,224,089**

9. 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 (IMF) 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 2011, Tonga's membership subscription to the International Monetary Fund was SDR6,900,000 (2010: SDR6,900,000). Of this total amount, SDR 1,711,633 (2010: SDR1,711,633) had been paid in foreign currencies, shown in the Balance Sheet as Reserve Tranche Position, 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.

(iii) Special Drawing Rights holdings is an interest bearing international reserve asset created by the IMF and is allocated to members on the basis of their quotas in the Fund. As at 30 June 2011, the Special Drawing Rights holdings had a balance of SDR7,080,700 (2010: SDR7,074,008).

10. OTHER ASSETS

	2011 $	2010 $
Staff loans and advances	434,851	469,770
Currency and numismatics	2,881,307	3,069,464
Other assets	60,826	247,196
	$3,376,984	**$3,786,430**

The amount charged to the statement of comprehensive income for currency expense is based on the total cost of notes and coins issued for circulation.

11. PROPERTY, PLANT & EQUIPMENT

	Leasehold & Buildings $	Computers & Office Equiptment $	Furniture & Fitting $	Motor Vehicles $	Work in Progress $	TOTAL $
At 1 July 2009						
Cost	11,657,801	1,526,004	130,468	224,571	-	13,538,844
Accumulated depreciation	(3,930,386)	(1,168,276)	(130,468)	(138,438)	-	(5,367,568)
Net book value	7,727,415	357,728	-	86,133	-	8,171,276
Year Ended 30 June 2010						
Opening net book value	7,727,415	357,728	-	86,133	-	8,171,276
Additions	44,318	702,796	-	-	124,454	871,568
Disposals	-	-	-	-	-	-
Transfer in/(out)	-	-	-	-	-	-
Depreciation	(235,187)	(135,076)	-	(28,793)	-	(399,056)
Closing net book value	7,536,546	925,448	-	57,340	124,454	8,643,788
At 30 June 2010						
Cost	11,702,118	2,208,948	130,468	176,640	124,454	14,342,628
Accumulated depreciation	(4,165,572)	(1,283,500)	(130,468)	(119,300)	-	(5,698,840)
Net book value	7,536,546	925,448	-	57,340	124,454	8,643,788
Year Ended 30 June 2011						
Opening net book value	7,536,546	925,448	-	57,340	124,454	8,643,788
Additions	416,130	145,621	-	-	51,715	613,466
Disposals	(5,046)	-	-	-	-	(5,046)
Transfer in/(out)	124,454	-	-	-	(124,454)	-
Depreciation	(193,453)	(123,107)		(28,793)	-	(345,353)
Closing net book value	7,878,631	947,962	-	28,547	51,715	8,906,855
At 30 June 2011						
Cost	12,005,851	2,247,973	127,834	176,640	51,715	14,610,013
Accumulated depreciation	(4,127,220)	(1,300,011)	(127,834)	(148,093)	-	(5,703,158)
Net book value	7,878,631	947,962	-	28,547	51,715	8,906,855

NATIONAL RESERVE BANK OF TONGA

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS YEAR ENDED 30 JUNE 2011

12. (a) FOREIGN CURRENCY DEMAND DEPOSITS

	2011 $	2010 $
Government of Tonga	3,980,574	10,353,467
Other institutions	58,159	53,838
	$4,038,733	**$ 10,407,305**

(b) LOCAL CURRENCY DEMAND DEPOSITS

	2011 $	2010 $
International banks	27,753	24,292
Domestic banks	92,959,434	60,465,748
Government of Tonga	33,224,682	25,905,638
	$126,211,869	**$ 86,395,678**

13. PAYABLE TO GOVERNMENT

	2011 $	2010 $
Amount payable to Government in accordance with Section 8(3) of the National Reserve Bank of Tonga (Amendment) Act 2007	**$2,111,513**	**$ 974,359**

14. CURRENCY IN CIRCULATION

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

	2011 $	2010 $
Notes	32,698,147	31,159,667
Coins	1,827,342	1,764,642
	$34,525,489	**$ 32,924,309**

15. STATUTORY RESERVE DEPOSITS

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

16. OTHER LIABILITIES

	2011 $	2010 $
Other creditors and accruals	3,694,629	491,667
Payable to the National Reserve Bank of Tonga Staff Provident Scheme – refer note below	465,176	191,400
	$4,159,805	**$ 683,067**

Funds belonging to the National Reserve Bank of Tonga Staff Provident Scheme are held with the Bank in this account.

NATIONAL RESERVE BANK OF TONGA

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS YEAR ENDED 30 JUNE 2011

17. EMPLOYEE PROVISIONS

	2011 $	2010 $
Opening balance	92,535	57,990
Entitlements during the year	87,803	101,370
Utilised/reversals	(65,008)	(66,825)
	$115,330	**$ 92,535**

18. CASH AND CASH EQUIVALENTS

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

	2011 $	2010 $
Cash on hand	2,092,242	115,083
Short term investments and current accounts	180,072,472	145,224,089
	$182,164,714	**$ 145,339,172**

19. RELATED PARTIES

Identity of related parties

The Bank's ultimate parent entity is the Government of the Kingdom of Tonga.

The Board of Directors during the financial year ended 30 June 2011 were Steve Edwards (Chairperson), Siosi Mafi (Governor), HRH Princess Salote Pilolevu Tuita, Richard Prema, 'Aisake Eke and Tiofilusi Tiueti.

During the year, the following executives were identified as key management personnel of the Bank: Siosi C Mafi (Governor), Jessie Cocker (Deputy Governor), Lata Tangimana (Manager Accounts and Currency), Elizabeth Baker (Manager Administration and Information Systems), 'Ungatea Latu (Manager Financial Institutions and Markets) and 'Anapuli Matoto (Manager Research).

The Bank contributes to the National Reserve Bank of Tonga Staff Provident Fund in accordance with the Provident Scheme Rules.

Transactions with related parties

In the normal course of operations, the Bank enters into transactions with related parties identified above.

The transactions with the Government of the Kingdom of Tonga include banking services, foreign exchange transactions and registry transactions.

19. RELATED PARTIES - continued

The funds of the Provident Scheme are invested within the Bank at an average rate of 3.96% per annum. The total interest paid by the Bank for the financial year amounted to $10,587.65. The Trustees of the Provident Scheme are indemnified by the Bank against all losses, damages or other costs which may be sustained or suffered by or made against a trustee as a result of any act or omission committed by the Trustee or Trustees which is not a breach of trust on the part of the Trustee.

Transactions with director related entities include purchases of goods and services and receipt of rental and utilities income as follows:

	2011	**2010**
	$	**$**
Rental and utilities income – Tonga SAT	70,900	68,733
Rent receivable from Tonga SAT	-	137,372
Rent received in advance from Tonga SAT	67,852	-
Purchase of goods	379	2,153

The Directors are paid fees and sitting allowances for services rendered. The Directors are also entitled to a retirement fund which at year end amounted to $150,875. The Bank also provides non-cash benefits to the Executive Directors and executive officers in addition to their salaries.

Total remuneration below is included in 'administrative costs.'

	2011	**2010**
	$	**$**
Executive officers	331,899	288,199
Director's fees and remuneration	46,639	43,862
	$378,538	**$ 322,061**

20. COMMITMENTS

(a) Operating lease commitments

Operating lease expenditure and commitments contracted for are payable as follows:

Details of the major operating leases are as follows:

(i) On 28 July 1992 the bank entered into an agreement with His Majesty the King of Tonga to rent the property in Fasi Moe Afi for 100 years ending 27 July 2091. Under the agreement, rent is payable at $3,000 per year.

(ii) On 6 April 1990 the bank entered into an agreement with His Majesty the King of Tonga to rent the property in Kolofo'ou for 100 years ending 5 April 2089. Under the agreement, rent is payable at $2,000 per year.

Total commitments for future lease rentals which have not been provided for in the accounts are as follows:

	2011	2010
	$	$
Due not later than one year	5,000	5,000
Due later than one year but not later than five years	20,000	20,000
Due later than five years	376,000	381,000
	$401,000	**$406,000**

(b) Capital and other commitments

	2011	2010
	$	$
Commitment not provided for in the financial statements are as follows:		
Foreign exchange transactions	**$3,598,404**	-
Capital commitment: approved and contracted	-	**$424,046**

21. CONTINGENT LIABILITIES

Contingencies not otherwise provided for in the accounts and which existed at 30 June 2011 comprise:

(i) Contracts for foreign exchange transactions was nil (2010: $nil)

(ii) In accordance with the accounting policy in Note 2(e), 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.

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:

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.

23. EVENTS SUBSEQUENT TO BALANCE DATE

No charge on the assets of the Bank has arisen since the end of the financial year to the date of this report to secure the liabilities of any other person.

No contingent liability has arisen since the end of the financial year to the date of this report.

No contingent or other liability has become enforceable or is likely to become enforceable within a period of twelve months after the date of this report which, in the opinion of the directors, will or may affect the ability of the Bank to meet its obligations as and when they fall due.