

NATIONAL RESERVE BANK OF TONGA

Monetary Policy Statement
February 2015

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Issued by: National Reserve Bank of Tonga
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Overview

Recent Developments

The outlook for the Tongan economy remains positive. Real Gross Domestic Product (GDP) is expected to record growth of 2.2% in 2014/15 supported by positive spillover effects from the declining global oil prices and low inflation. This is a downward revision from an estimate of 2.9% in the August 2014 Monetary Policy Statement, which largely reflects an unexpected contraction in the agricultural sector due to adverse weather conditions and delays to large construction projects scheduled for the year. Consumer prices recorded the first deflation rate since May 2013 of -1.1% over the 12 months to February 2015.

Gross official foreign reserves have increased over the past six months, reaching a new record high of \$293.6 million at the end of December 2014 before declining to \$281.3 million at the end of February 2015. This is in line with a surplus of \$0.2 million in the balance of overseas exchange transactions (OET) over the year to February 2015, which is much lower than the surplus in the last publication. The lower surplus reflected a higher current account deficit and a lower capital account surplus. Remittances, the major source of overseas exchange earnings, increased by 10.1% over the past six months to February 2015.

Despite the continued concern with the overall quality of the banks' loans, the banking system continued to be profitable, maintaining strong liquidity and capital positions. Credit growth continued to rise, reaching its highest level since February 2011, whilst maintaining narrow interest rate spreads. Broad money rose by 1.7% over the past six months to February 2015 driven by an increase in net domestic assets.

Over the six months to February 2015, net credit to government fell by more than 5.0% compared to an increase of about 12% over the six months to August 2014. The outcome reflects an increase in government deposits more than offsetting a slight increase in banks' holdings of government bonds.

Outlook

Looking forward, the NRBT anticipates stronger growth for 2015/16 of 3.2%, driven by a rebound in primary activities, stronger financial intermediation and expected improvements in the tourism and construction sectors. Headline inflation will continue to remain negative until the end of this calendar year.

The outlook for the gross official foreign reserves is expected to remain high over the remainder of the 2015 and 2016 financial year, well above the NRBT minimum range of 3 – 4 months of imports coverage. Remittances are anticipated to rise on the back of upcoming festivities such as the coronation and church conferences, although the growth will be slow. However, a proposed 1% levy on all private transfer receipts and payments poses a risk to the outlook on the foreign reserves as this will affect the country's overall balance of payments position.

Broad money is expected to increase as credit growth is likely to grow by over 10%, with anticipated increases in net credit to government in the next six months. Liquidity in the banking system is also projected to remain high while interest rate spread is expected to remain low. Monetary conditions may be affected with the takeover of Westpac Bank of Tonga by Bank of South Pacific; the NRBT includes non-banks within its regulatory framework; and the NRBT's commitment to promoting financial inclusion. However, challenges to financial stability remain, particularly due to a recent court decision which may undermine the banks' ability to recover non-performing loans. This may also discourage credit extension by the banks.

The fiscal position has improved according to the IMF 2015 Article IV report, supported by large grant inflows but spending pressures for government remains high in the near term. The NRBT will assess the impact of the Government's 2015/16 fiscal budget on the monetary policy targets.

In light of the recent developments and the outlook on the monetary policy targets, the current accommodative monetary policy setting is considered appropriate in the next six months. Nevertheless, the NRBT will continue to closely monitor the country's economic developments and financial conditions to maintain internal and external monetary stability, promote financial stability and a sound and efficient financial system to support macroeconomic stability and economic growth.



Sione Ngongo Kioa
Governor

1. Global Developments

World Growth

The International Monetary Fund (IMF) in its April 2015 World Economic Outlook (WEO) estimated global growth to remain moderate at 3.4% by December 2014 compared to its previous estimate of 3.3%. Furthermore, global growth is forecasted to rise further by 3.5% and 3.8% in the pursuing years, supported by lower global oil prices.

World Oil Prices

World oil prices rebounded in February 2015 after hitting its lowest level (around US\$46 a barrel) in January 2015 since March 2009. The result still saw oil prices decreased by more than 40% over the six months to February. This largely reflects excess supplies in the United States (US) with very high production levels and weak demand from North America, Eurozone and China. The declining oil prices have benefitted oil importing countries and have contributed to growth in the world economy. However, the falling oil prices seem to have dampened growth for all oil exporters, especially in the Eurozone with the exception of the United States. In Pa'anga terms, oil prices have also decreased by around 40% over the same period.

Advanced Economies

WEO estimates the US economy to have risen further in 2014 since its last release from 2.2% to 2.4%. The growth is driven by the unexpected large production of crude oil in the US, driving global oil prices down and strengthening the US dollar. In 2015 and 2016 the US economy is predicted to accelerate by a further 3.1%. This is slower than previously expected due to the stronger US dollar negatively affecting exports. Unemployment rates declined to 5.5% in February 2015 allowing the Federal Reserve to consider increasing the interest rates this year.

The Eurozone is still experiencing challenges following the Global Financial Crisis as business investment is still weak, unemployment rates high at 11.1%, and inflation and Gross Domestic Product (GDP) barely above zero. Challenges were further exacerbated by the declining global oil price which saw the IMF revise GDP growth downwards for both 2015 and 2016 as the Eurozone is a major exporter of oil.

China's economic growth continues to slow down and is estimated to be at its slowest pace in six years, albeit comparatively high at approximately 7%. The trend is not expected to change in the coming years due to the ongoing property market slump. However, the People's Bank of China unexpectedly cut interest rates at the end of February as a way to stabilize its economic growth.

Japan's economic growth is estimated to have slightly contracted in 2014 due to weaker than expected demand following the consumption tax hike in April 2014. However, it is expected to recover at a moderate pace supported by the weaker Yen and lower oil prices in the following years.

The Australian economy grew by 2.7% in 2014, lower than last anticipated due to the declining iron ore prices softening growth in the mining sector. The declining global commodity prices will continue to drag on Australia's growth in the near future. However, unemployment rate is relatively steady at just above 6% and inflation is low. The Reserve Bank of Australia (RBA) cut its official interest rates to 2.25% in February and is expected to leave its official interest rates unchanged until well into 2015. The RBA continues to maintain a supportive monetary policy to further boost growth in the long term.

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

	Real GDP growth (%)			Inflation (%)			Unemployment* (%)		
	2014	2015 ^f	2016 ^f	2014	2015 ^f	2016 ^f	2014	2015 ^f	2016 ^f
New Zealand	3.2	2.9	2.7	0.8	1.6	1.8	5.4	5.3	5.2
Australia	2.7	2.8	3.2	1.7	2.6	1.9	6.1	6.4	6.2
United States	2.4	3.1	3.1	0.9	0.5	2.1	6.2	5.5	5.2
China	7.4	6.8	6.3	1.5	1.2	1.5	4.1	4.1	4.1
Japan	-0.1	1.0	1.2	2.6	0.9	0.5	3.6	3.7	3.7
Euro Area	0.9	1.5	1.7	-0.2	0.2	1.2	11.6	11.1	10.6

Note: f – forecast; * for month of December

Source: IMF (World Economic Outlook, April 2015)

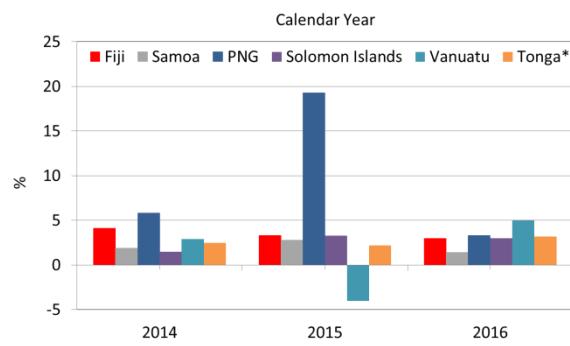
The New Zealand economy expanded by 3.2% in 2014, reflecting ongoing strength in consumption, business investment and construction activity. Inflation is at the lower end of the target range at 1.6%, and the unemployment rate remains low at 5.4%.

South Pacific Economies

South Pacific economies are also estimated by WEO April 2015 to have improved in 2014 except for Solomon Islands and Fiji who are expecting subdued growth. The declining global oil prices are expected to contribute to growth in all the South Pacific economies for 2015 as they are net oil importers. Fiji's growth is still expected to dampen in 2015 while Solomon Islands will rebound with stronger growth in 2015. Papua New Guinea is anticipating a one-off national record growth of around 20% due to the production of liquefied natural gas coming online in 2015. Contrastingly, Vanuatu was devastated by Cyclone Pam which left the country in ruins and so is

expected to contract in 2015 but will record stronger growth for 2016 as the economy recovers.

Figure 1: Real GDP Growth Projection



The IMF expects inflation to generally rise in 2015, except for Papua New Guinea and Solomon Islands. Inflation expectations are also broadly higher for 2016.

2. Tonga's Economic Growth

Real GDP Growth

Real GDP is expected to record growth of 2.2% in 2014/15 supported by positive spillover effects from the declining global oil prices and low inflation. However, this is a downward revision from the August 2014 Monetary Policy Statement (MPS) estimate of 2.9% which largely reflects an unexpected contraction in the agricultural sector due

to adverse weather conditions and delays to large construction projects scheduled for the year. Looking forward, the NRBT anticipates stronger growth for 2015/16 of 3.2% driven by a rebound in primary activities, stronger financial intermediation and expected improvements in the tourism and construction sectors.

Table 2: Real GDP Growth Forecast

	Year ended				
	Jun-14 %	Jun-15 (Aug-14 MPS) %	Jun-15 (Revised) %	Jun-16 (Aug-14 MPS) %	Jun-16 (Revised) %
GDP	2.5	2.9	2.2	3.1	3.2
Primary Production	3.8	2.9	-2.3	3.8	2.1
Agriculture	4.0	3.0	-3.0	4.0	2.0
Forestry	3.0	2.0	0.0	2.0	2.0
Fishing	2.5	2.5	1.0	3.0	3.0
Secondary Production	2.8	6.3	6.9	5.0	5.3
Mining and quarrying	3.5	3.0	5.0	2.5	2.5
Manufacturing	0.5	0.5	3.0	1.5	3.0
Utilities	2.0	2.5	3.0	3.5	3.5
Construction	5.0	10.0	10.0	7.0	7.0
Tertiary Production	2.2	2.5	2.8	2.7	3.3
Trade	3.5	3.5	4.0	3.5	4.0
Hotels, restaurants	1.0	2.0	5.0	3.5	5.0
Transport, communication	4.0	4.0	5.0	4.0	5.0
Financial intermediation	5.0	5.0	4.0	5.0	5.0
Real estate, business services	3.0	3.0	3.0	2.3	3.0
Public administration	1.0	1.5	2.0	1.5	1.5
Education	1.0	1.0	2.0	1.0	2.0
Health and social work	1.0	1.0	1.0	1.0	1.0
Recreational, cultural activities	1.0	1.0	1.5	1.0	2.0
Other community services	1.0	1.0	1.0	1.0	1.0
Ownership of dwellings	0.5	1.0	0.1	2.0	3.0
Other *	1.5	1.0	1.0	1.5	1.5

* Includes taxes minus subsidies and imputed bank service charges

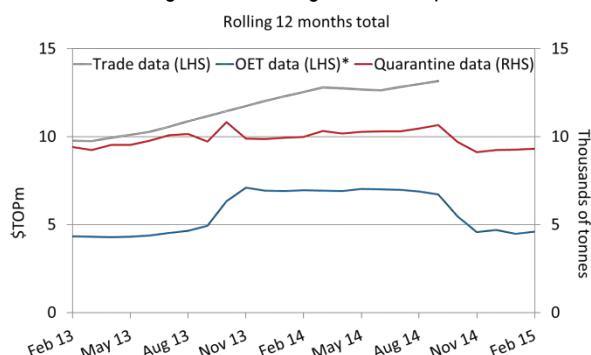
Source: NRBT

Primary Production

According to NRBT liaisons with growers, droughts and adverse weather conditions were the main drivers for the fall in agricultural production in 2014/15. Squash exports volume declined the most by 42.4% and coconuts by 6.1%, driving a 6.9% drop in total agricultural exports volume. Despite increases in other products, the agricultural sector is expected to decline following a very productive year in 2013/14.

However, the agricultural sector is expected to recover in 2015/16. Growers are expecting to expand the range of produce they export to other produce such as zucchini and watermelon by 2015/16. Continued lending via the Government's managed funds may provide future stimulus to the sector and help exporters enter new markets. Training programs, packing facilities as well as growth strategies initiated by the Agriculture Growth Committee (AGC) are also expected to help boost and facilitate agricultural activities going forward. Uncertainty in weather conditions poses the most serious risk to the outlook of the sector.

Figure 2: Total Agricultural Exports



* Excludes all agricultural receipts that are channeled through foreign exchange dealers.
Data sources: NRBT; Banking System; Ministry of Agriculture, Forestry, Food and Fisheries; Tonga Department of Statistics

Fisheries production is expecting slower growth in 2014/15 of 1.0%, a downward revision from an initial 2.5% growth estimate. Liaisons indicate lower than expected catch rates due to warm weather and recent underwater volcanic activity. Looking forward the fisheries sector is expected to grow moderately with the availability of funds through the Fisheries Development and Export Fund (FDEF) and the removal of taxes on fishing gear.

The forestry sector is expected to experience little to no growth in 2014/15. Contrary to expectations, increases in construction work such as the Tonga Village Upgrade has had minimum spillover effects for the forestry sector. However, looking forward, the

increase in private construction works and the resumption of harvest and exportation of sandalwood are expected to drive some growth in the sector.

Secondary Production

Delays to major public projects such as the Ha'apai Reconstruction from 2013/14 are contributing to the strong positive outlook for the construction sector and the economy as a whole in 2014/15. A number of both public and private projects are already in the construction pipeline, such as the Retirement Fund Board building, Adiloas building and various church buildings. The outlook is quite positive as liaisons indicate more construction work from other delayed projects such as the St. George Palace and the Faua wharf project to be resumed in the near future. Additionally, other major projects are expected to start taking place in preparation for the 2019 South Pacific Games such as the establishment of infrastructure for the games and developments to accommodation places. Furthermore, the renovation of the International Dateline Hotel by the Tanoa Group is expected to benefit the construction, trade and tourism sectors.

The developments in the construction sector are expected to have some spillover effects for mining and quarrying activities, manufacturing and the utilities sector. The utilities sector is expected to benefit from the growth in the number of buildings and construction work happening throughout the years.

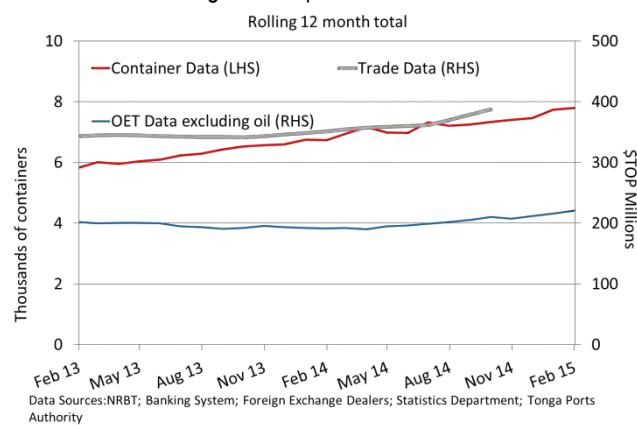
The manufacturing sector is also expected to benefit from the construction activity through the demand for raw materials such as bricks and paint for housing. Also, anticipated recovery of 'hiapo' and 'lou'akau' plantations used for handicrafts in Ha'apai will also help boost activities in the sector. NRBT expects growth in tourist arrivals in the near future to further stimulate activities in the handicrafts sector. Liaisons also indicate available new markets for handicrafts are also helping to boost activities in the sector.

Tertiary Production

Partial indicators show the distributive and trade sector will record strong growth in 2014/15. Container registrations reached its highest level ever on record during the 2014/15 financial year and have shown a 10.3% increase in the first half of the financial year compared to that of the previous year. The sector is expected to continue to grow, benefitting from a pick-up in household lending

activity. However, the recent depreciation in Tonga's real exchange rates poses a risk to the growth in the distributive sector.

Figure 3: Import Indicators



The NRBT is anticipating bank lending to continue to grow supported by an increase in government grants and incentives. There is also excess liquidity in the banking system which the NRBT anticipates will support strong lending growth in the future. Growth may also be encouraged by potential competition from the takeover of Westpac Bank of Tonga before the end of 2014/15 financial year.

The tourism sector is expected to thrive in the next few years supported by major events held locally such as the upcoming coronation and the continuing economic growth in Tonga's key source countries for tourism. Preliminary numbers for cruise ship arrivals

show growth for the 2014/15 financial year and was further supported by redirected ships due to unruly weather conditions in the region.

The declining global oil prices is expected to have a positive effect on transportation and travel costs, which will benefit the tourism sector in the near future. The travel ban imposed on the domestic airline services has been partially lifted and the NZ grant for tourism has been approved to be released. This should contribute to growth in the upcoming financial year and onwards. Available government grants and development projects mapped out in the Tourism Roadmap will also drive long term growth in the sector.

Unemployment

As reported in the last Monetary Policy Statement, the unemployment rate remains at 6.5%. However, an agricultural census currently being undertaken may provide an update to this figure in the near future. Tonga's unemployment figures are difficult to compare with other countries because of a high incidence of subsistence work.

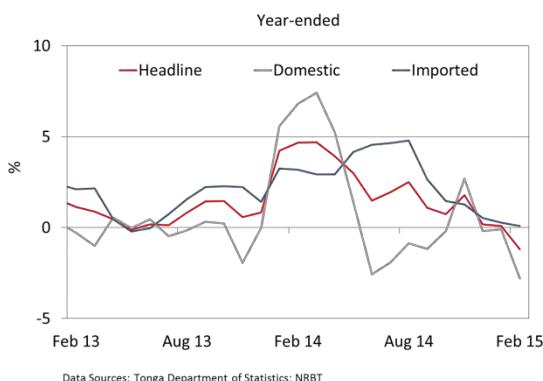
The NRBT has been investigating new avenues for the production of more timely labor market data. Recently, job advertisements posted in local media show an upward trend over the six months to February 2015. Despite this being a partial indicator for unemployment, it also shows the capacity for employment.

3. Promoting Low and Stable Inflation

Recent Developments

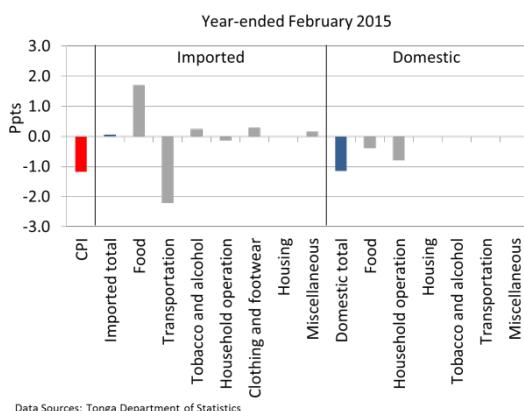
Consumer prices declined over the 12 months to February 2015 by 1.1% compared with a 2.5% rise recorded in August 2014. This is the first deflation rate since May 2013.

Figure 4: Inflation



The decrease in consumer prices was mainly driven by a 2.9% decline in domestic prices. The largest decrease in domestic prices was for the Household Operation component, particularly electricity prices which fell by 13.9% over the year. This coincided with a 42.8% decline in world oil prices. In addition, Domestic Food prices fell also, specifically Fruit & vegetables, and Meats, fish and poultry prices.

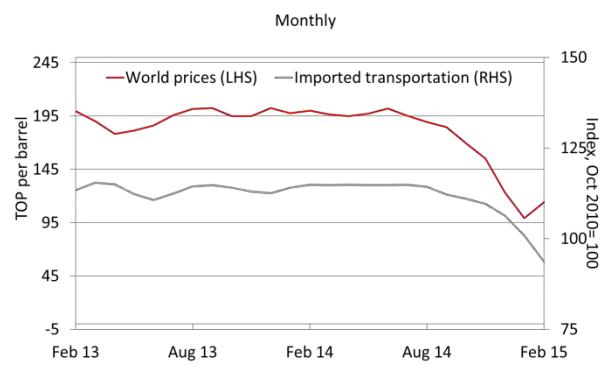
Figure 5: Contributions to Inflation



Imported inflation increased by 0.1% over the year. Major contributor to the rise was food prices, particularly Fruit & vegetables and Meats, fish and poultry prices. Additionally, prices for Imported Clothing and Footwear, and Miscellaneous goods and services rose. Despite lower food prices in New Zealand and a stronger Pa'anga against the New Zealand Dollar, Imported prices increased. This was

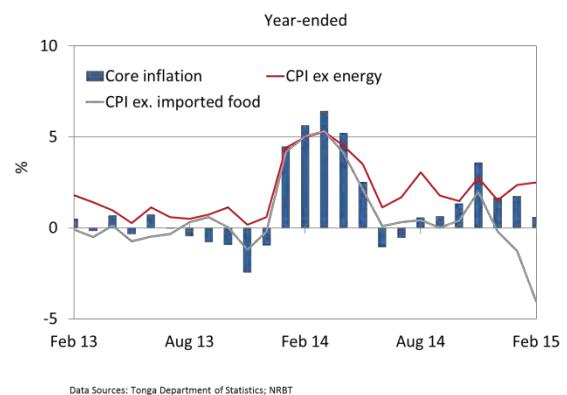
possibly due to high demand which led importers to raise prices. However, the lower global oil prices positively affected Imported Transportation and Household Operation components which had partially offset the overall rise for imported prices.

Figure 6: World Oil Prices



The rate of core inflation, which excludes imported food and imported energy prices, increased slightly over the year to February by 0.6%. This increase is slightly higher than the 0.5% rise recorded over the year to August 2014.

Figure 7: Alternative Inflation Measures

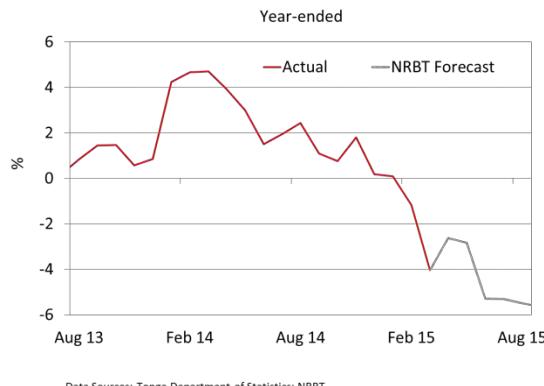


Outlook

The NRBT projects that headline inflation will continue to remain negative until the end of this calendar year, which is lower than the 1.3% projected in the last statement. The main factors that caused the difference include the rapid decline in global oil prices affecting prices for both imported and domestic components. However, imported prices, particularly for food, continued to increase gradually since the last statement. As most of

Tonga's imported food is New Zealand made, the higher imported prices were driven by rises in New Zealand food prices and the strong New Zealand dollar.

Figure 8: Headline Inflation



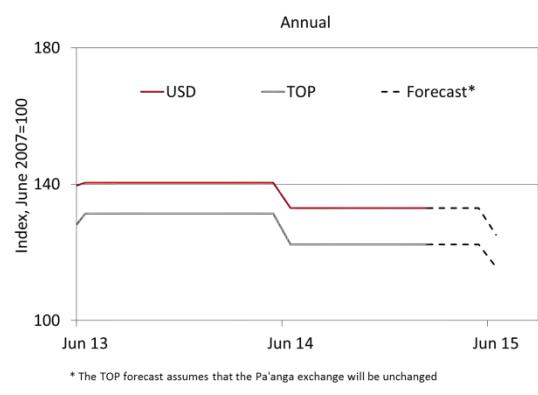
Data Sources: Tonga Department of Statistics; NRBT

Note: The actual inflation rate for March 2015 has been included

The forecast is based on three key factors:

- The IMF expects world food prices to be about 6% lower over calendar year 2015, owing to an increase in world food supply.

Figure 9: World Food Prices



- Market economists expect world oil prices to increase by around 27% over calendar year 2015, due to projected decline in crude stocks amid elevated political tensions in some oil producing countries.
- Exchange rates are assumed to be unchanged.

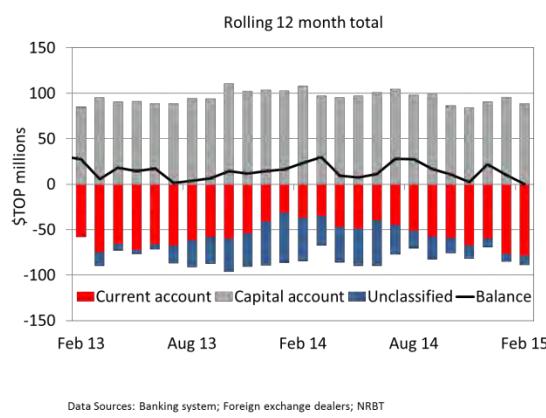
Global economic uncertainties, weather patterns and other factors such as world oil supply, pose a large risk to the inflation outlook.

4. Maintaining Adequate Level of Foreign Reserves

Balance of Overseas Exchange Transactions

The balance of overseas exchange transactions (OET) was a surplus of \$0.2 million over the year to February 2015, though much lower than the surplus in the last publication. The lower surplus reflected a higher current account deficit and a lower capital account surplus.

Figure 10: Balance of Overseas Exchange Transactions

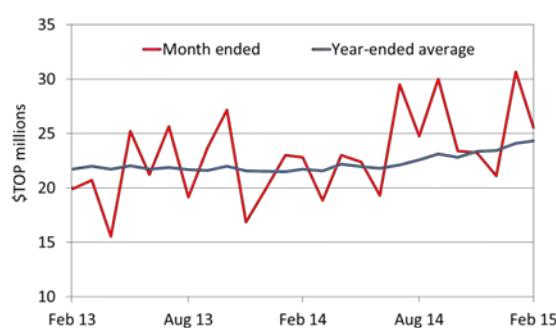


Data Sources: Banking system; Foreign exchange dealers; NRBT

Current Account

Import payments rose by 11.7% to \$154.0 million in the past six months to February 2015. Imports of wholesale and retail goods increased by 24.7%, reflecting higher domestic demand attributed to a 13.7% rise in remittances and growth in household loans over the same period.

Figure 11: Import Payments



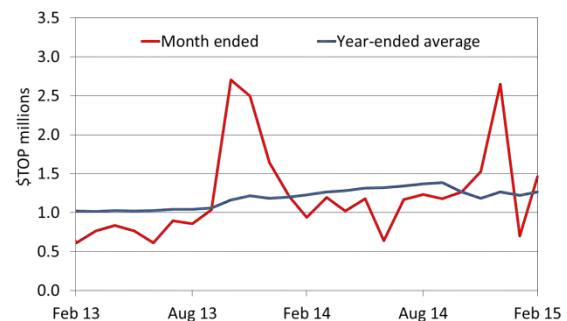
Data Sources: Banking system; Foreign exchange dealers; NRBT

Import of construction materials also rose by 7.7% reflecting the increase in the number of construction activities. The rise is supported by a pick-up in container registrations. The import of fuel products also increased with the economy taking advantage of falling global oil prices. Moreover, on an annual

basis, import payments increased by 11.9% to \$291.8 million in February 2015, due to a pickup in construction and vehicle payments.

In the six months to February 2015, export receipts increased by 36.5% due mainly to receipts from squash exports. However in the year to February 2015, agricultural exports receipts fell by 34.1% while marine exports rose by about 30%. The exports proceeds received by foreign exchange dealers rose by approximately 40%. Therefore, total export receipts rose by 3.0% over the year.

Figure 12: Export Receipts

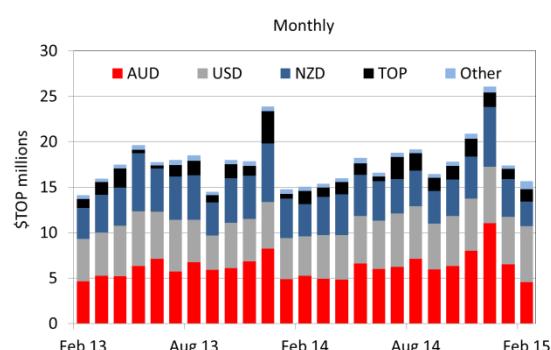


Data Sources: Banking system; Foreign exchange dealers; NRBT

Travel receipts over the past six months rose by 3.3%. This is supported by the rise in international arrival, which could be largely attributed to festivities such as Christmas and New Year. Over the year to February 2015, travel receipts declined by 28.5%.

Remittances, the major source of overseas exchange earnings, increased by 10.1% over the past six months to February 2015.

Figure 13: Remittances



Data Sources: Banking system; foreign exchange dealers; NRBT

In year ended terms, remittances rose by 3.9% to a total of \$221.2 million. The largest share of remittances, 35%, came from Australia followed by 30% from the US and 23% flowing from New Zealand. Positive growth in the Australian and US economies and the weaker Tongan pa'anga contributed to the rise. Remittances as a share of GDP are around 26% as at June 2014.

Over the year to February 2015, the current account balance recorded a deficit of \$78.9 million, more than double the deficit from the previous year. This was the result of rising import payments and a decline in travel receipts.

Capital Account

Capital inflows fell by 3.1% over the past six months to February 2015 due to lower private capital receipts, mainly in the form of interbank transfers, which more than offsets a rise in official capital receipts. Capital payments also fell by 26.3% over the six months to February driven by fewer private capital payments. Therefore, capital account balance was a surplus of \$45.9 million over the six months to February.

In year ended terms, capital account balance was a surplus of \$88.9 million, 17.5% lower than over the year to February 2014. The lower surplus reflected a fall in capital receipts explained by the delay in receipts of budget support and a pickup in private capital payments.

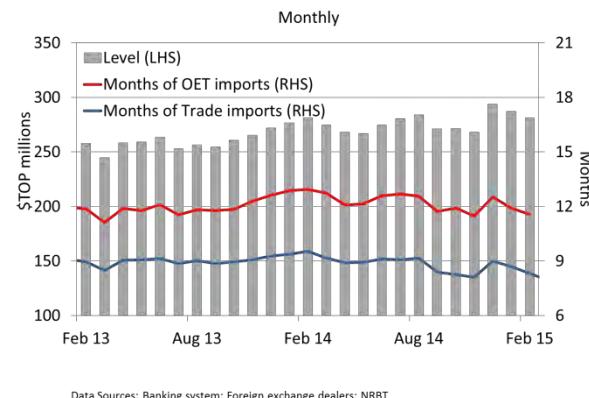
The balance of unclassified transactions was an average outflow of \$0.8 million per month over the year ended February 2015 compared to an average outflow of \$4 million over the same period last year. The lower number of unclassified transactions reflects better coverage and classification of OET data.

Official Foreign Reserves

Gross official foreign reserves have increased significantly over the past six months, reaching a new record high of \$293.6 million at the end of December 2014 before declining to \$281.3 million at the end of February 2015. This is in line with the lower surplus in the balance of OET compared to the surplus in August 2014. Foreign reserves when

measured as a ratio of imports have remained high at 8.3 months of import coverage at the end of February 2015, well in excess of the NRBT minimum range of 3-4 months.

Figure 14: Gross Official Foreign Reserves



Data Sources: Banking system; Foreign exchange dealers; NRBT

Exchange Rates

The Nominal Effective Exchange Rate (NEER) index has remained unchanged over the past six months to February 2015, implying that the pa'anga has been stable against the currencies of its major trading partners. On the other hand, the Real Effective Exchange Rate (REER) fell by 1.2% supporting the competitiveness of Tongan produce overseas evident from higher export returns over the year.

Outlook

The NRBT expect the level of foreign reserves to increase over the remainder of the 2015 financial year and again over the 2016 financial year. The forecast stems from a balance of key factors:

- The trade balance is expected to deteriorate with higher imports being fuelled by firmer lending outcomes.
- Remittances are anticipated to rise on the back of upcoming festivities such as the coronation and church conferences, although the growth will be slow.
- Budget support from donor countries will continue to be received, although the timing will pose a risk to the outlook.

A proposed 1% levy on all private transfer receipts and payments poses risk to the foreign reserves outlook, as this will affect the country's overall balance of payments position.

5. Promoting a Stable Financial System

Credit growth continues to rise, reaching its highest level since February 2011 and narrow interest rate spreads remains. In line with the high banking system liquidity, foreign reserves remain well above the minimum range.

Money Supply

Broad money rose by 1.7% over the past six months to February 2015 driven by an increase in net domestic assets more than offsetting a decline in net foreign assets. The rise however is lower than a 3.6% growth over the six months to August 2014 due to a decline in commercial banks' foreign assets. However, in year ended

terms, broad money rose by 7.5%, led by a 36.5% increase in net domestic assets more than offsetting a 1.4% decline in net foreign assets. An increase in currency in circulation and saving and term deposits also contributed to the rise in broad money.

Liquidity in the banking system increased markedly over the past six months, reaching a new record high of \$156.4 million in January 2015 before falling to \$149.9 million in February. Over the year to February 2015, banks' liquidity rose by 4.8%. The rise is attributed mainly to a pickup in foreign reserves.

Table 3: Consolidated Balance Sheet of Depository Corporations

	Level			YoY change	
	Feb 15 \$TOPm	Aug 14 \$TOPm	Feb 14 \$TOPm	Feb 15 \$TOPm	%
Broad money liabilities	379.7	367.3	353.2	26.5	7.5
Currency in circulation	40.2	38.7	33.8	6.4	18.8
Demand deposits	137.1	135.1	132.7	4.4	3.3
Savings and Term deposits*	202.4	193.5	186.7	15.7	8.4
<i>equals</i>					
Net foreign assets	266.7	275.2	270.3	-3.7	-1.4
<i>plus</i>					
Net domestic assets	113.3	92.2	83.1	30.3	36.5
Gross bank lending**	305.6	287.8	279.0	26.6	9.5
Other***	-192.6	-195.7	-196.1	3.5	-1.8

* Also includes very minor amounts for securities other than shares.

** Differs slightly from standard measures of bank lending by amounts classified as accrued interest.

*** Includes mostly the banks' and NRBT's capital accounts, and their net claims on the central government.

Sources: Banking System; NRBT

Interest Rates

The weighted average interest rate spread slightly narrowed to 6.5% in February 2015 from 6.7% in August 2014. This was driven by an increase in deposit rates and a decline in lending rates. Active competition resulting in increased refinancing of loans across banks, as well as the continued high liquidity in the banking system largely supported the lower weighted interest rate spread. Commercial banks' building up their deposit base to fund the expansion of their loan book is still ongoing.

The weighted average rate on all bank loans fell by 21 basis points over the year to February 2015, due mainly to banks offering competitive interest rates on loans mostly to public enterprises. The weighted average interest rates on the key bank lending categories fell over the six months to February 2015, with the business category declining the fastest.

Lower weighted average lending rates supports a rise in new loan commitments to public enterprises, distribution, construction, manufacturing, and especially housing.

Weighted average deposit rates rose by 21 basis points over year to February 2015, led by an increase in savings and term deposits rates.

Figure 15: Interest rates spread



Figure 16: Deposit Rates

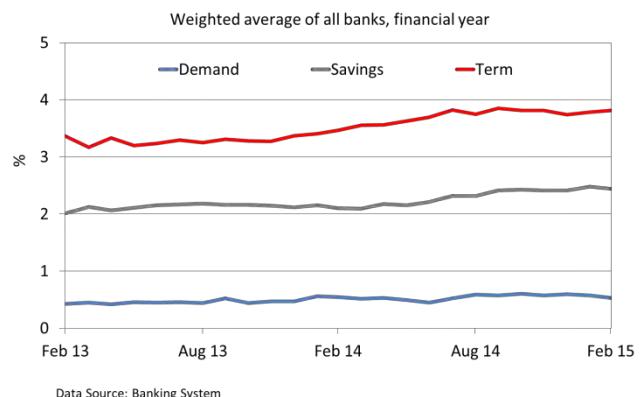


Table 4: Lending Rates

	Weighted average of all banks					
	Feb 15 % p.a.	Level as at Aug 14 % p.a.	Feb 14 % p.a.	Change over 6m to Feb 15 bps	Aug 14 bps	Loan share Aug 14 %
All	8.79	8.93	9.00	-14	-7	100
Housing	8.47	8.60	8.65	-13	-5	35
Other Personal	12.82	12.98	12.83	-16	15	18
Business*	7.76	8.07	8.24	-32	-17	25
Other	6.53	7.83	7.52	-130	31	21

*Included Statutory Non-financial Corporation and Other Financial Corporations

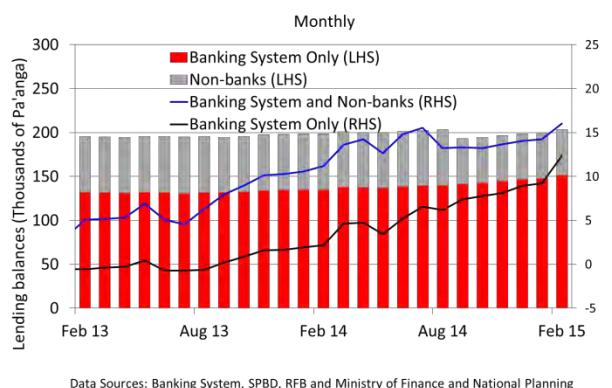
Source: Banking System

Lending

Total bank lending increased by 9.4% over the year to February 2015, which is similar to the growth over the year ended August 2014. This growth resulted from higher lending to households and businesses. Total loans extended by banks and non-banks grew by only 6.8% over the year reflecting lower on-lent loans by the government.

Household loans rose by 12.3% over the year to February 2015, driven mainly by an increase in housing and other personal lending. The increase in housing loans support growth in other sectors evident from an increase in import payments for construction materials, and wholesale and retail goods.

Figure 17: Household Lending



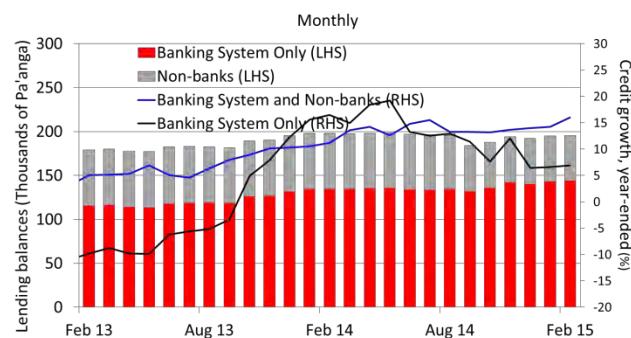
Data Sources: Banking System, SPBD, RFB and Ministry of Finance and National Planning

New household loan commitments rose significantly from around \$0.35 million to more than \$3.8 million over the year ended February 2015 which contributed to a 11.9% increase in housing loans. This is the highest growth since

August 2006. Furthermore, after adjusting for the non-bank lending programs, year-ended growth in household loans would have risen by 16.0%, reflecting an increase in South Pacific Business Development and Retirement Fund Board lending activities.

Loans to business increased by 7.0% over the year to February 2015, driven mainly by a rise in lending to public enterprises. New business loan commitments grew over the year to February 2015 particularly for public enterprises, distribution and construction sectors. Lending from the managed funds facilitated by Tonga Development Bank also contribute to the increase in business lending. The increase in outstanding loans for the construction sector is consistent with a rise in import payments for construction materials, reflecting the reconstruction at Ha'apai and the increasing number of private construction works.

Figure 18: Business Lending



Data Sources: Banking System, SPBD, RFB and Ministry of Finance and National Planning

Banking System Performance

Tonga's banking system remained strong and sound. The total assets of the financial system increased by 2.5% to \$575 million over the six months to February 2015 mainly due to a 7.0% growth in loans and advances and a 4% increase in the banks' Exchange Settlement Account balances. Total liabilities increased by 2.0% to \$442 million, due mainly to a 4.0% growth in total deposits. On the other hand, total provisions fell by \$2.7 million (13.4%), reflecting the clearance of provisioned loans during the six months up to February 2015.

The banking system continued to be profitable and strong liquidity and capital positions were maintained. The profitability of the total banking system improved over the six months ended February 2015 which was attributed mainly to higher interest income and a decline in non-interest expenses. Return on assets and return on equity therefore increased to 2.9% and 9.5% respectively, compared with 2.6% and 9.3% respectively in August 2014. Liquidity position of the banking system remained relatively stable and comfortably above the minimum requirements in the six months ended February 2015. Although total deposits grew, contributing to the higher Exchange Settlement Account balances, this was outweighed by the positive credit growth. The capital position of the banking system remained strong and the total risk-weighted capital ratio remained above the minimum ratio required by the Reserve Bank of 15% at 41.4% at the end of February 2015.

The overall quality of the banks' assets remained a concern over the six months to February 2015 but it has improved to a more manageable level compared to previous years. Total non-performing loans decreased by 15.5% to \$28.0 million over the six months to February 2015, representing 9.4% of total loans, improving from 1.6% six months ago. There are adequate provisions held against the non-performing loans.

Outlook

The IMF has forecasted broad money to increase by around 4% in this current financial year and to increase further by about 5% in the 2015/16 financial year. The rise is mainly attributed to an expected pickup in foreign reserves and domestic credit.

The NRBT is forecasting credit to grow by more than 10% in the next six months. This is based on continuous improvements in business confidence, imminent drawdowns of some large loan commitments, the continued low interest rates and the Government's managed funds scheme targeting the manufacturing, construction, tourism, agricultural and fisheries sectors. Commercial banks' prospects for credit growth remain positive. Growth will also be encouraged by potential competition from the bank takeover.

Tangible progress has been made in improving banks' balance sheets and strengthening the legal framework of the financial sector, but challenges to financial stability remain. Efforts have rightly focused on strengthening legal framework including amending the NRBT Act and the Financial Institutions Act. These would bring all financial institutions under the supervision of the NRBT and strengthen the enforcement powers of the NRBT. This coupled with the NRBT's commitment to promoting financial inclusion, could result in increased access to financial services, and therefore higher credit and deposit balances.

However, appropriate attention and action should be given to the increasing concerns with the credit environment. Likely outcome of recent court cases may undermine the banks' ability to recover non-performing loans and poses risks to the financial system and the credit growth outlook.

6. Fiscal Indicators

The IMF 2015 Article IV report states that Tonga's fiscal position has improved supported by large grant inflows but spending pressures for government remains high in the near term.

Banking system data shows net credit to government fell by more than 5.0% over the six months to February 2015 compared to an increase of about 12% over the six months to August 2014. The fall in net credit to government over the six months to February reflects an increase in government deposits more than offsetting a slight increase in banks' holdings of government bonds. This is largely due to the receipt of over \$10 million budgetary support and other non-budget receipts in the first half of the 2014-15 fiscal year.

Over the year to February 2015, net credit to government rose by more than 15%, underpinned by a fall in government deposits which more than offset an increase in banks' holdings of government bonds. The new bond issue increased the banks' bond holdings, leading to a rise of over 20% in domestic debt.

Going forward, it is anticipated that government receipts will increase in the next six months to August 2015 from budget support and a rise in public debt. This is however subject to the 2015/16 budget statement which is yet to be issued. The increase in public debt coincides with new bonds to be issued before the end of the 2014-15 financial year and a recently approved new loan from the World Bank for the Pacific Resilience Project. It is expected that this will further increase foreign reserves initially before the repayments commence.

Net credit to government is also expected to increase, leading to an increase in liquidity within the banking system and broad money. However, this is also subject to the proposed spending by the government in their 2015/16 budget statement which is due to be released in the near future. With the existing foreign debt, NRBT forecasted foreign reserves to remain above 3-4 months of imports to June 2016. The downside risk to this forecast would be additional foreign debt that the Government may wish to include in the 2015/16 budget. NRBT therefore needs to assess the implication of the government budget on monetary policy objectives.

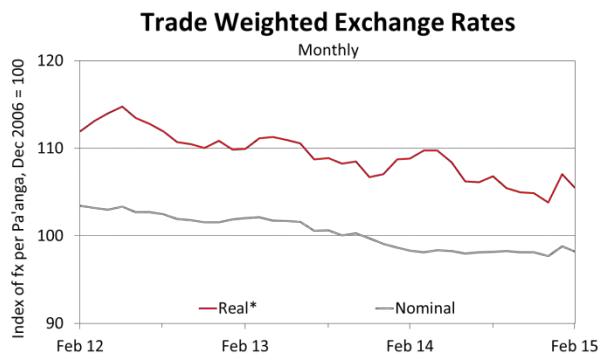
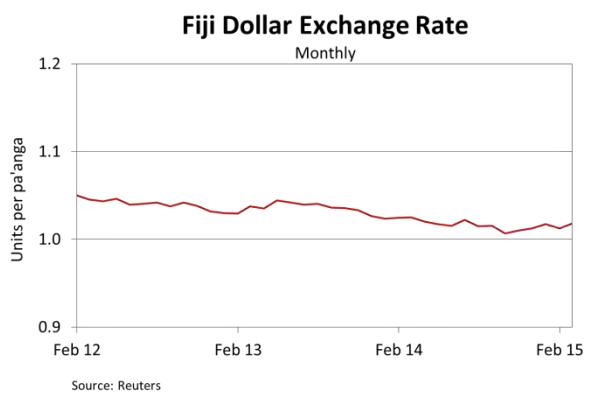
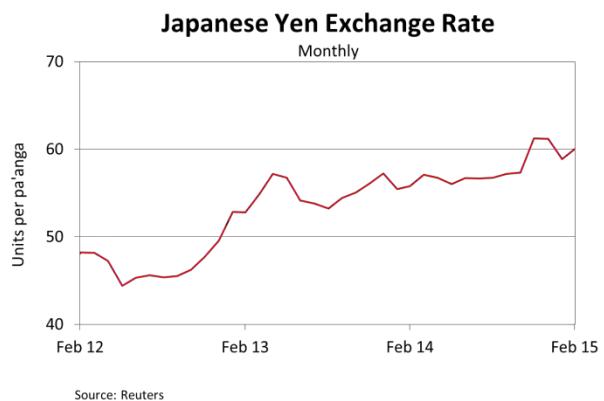
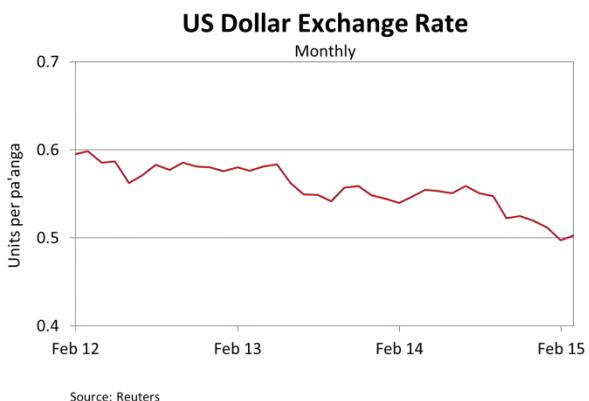
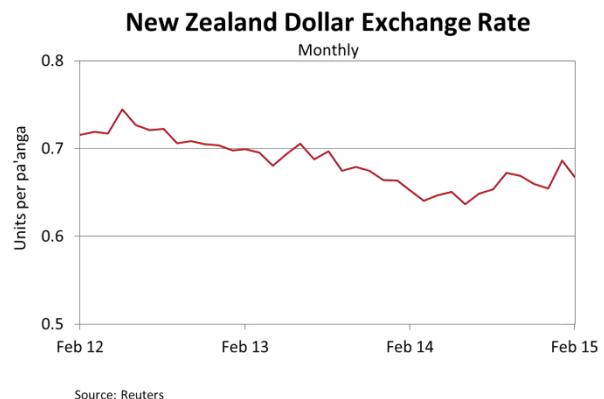
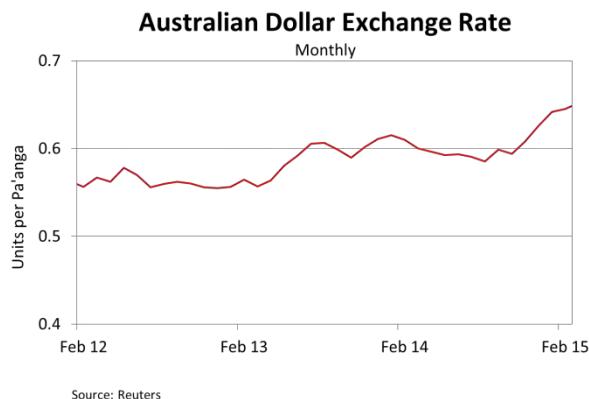
7. Monetary Policy Stance

The NRBT monetary policy remained accommodative over the past six months. The NRBT continues to project inflation to remain below the reference rate of 4% to 6% and for foreign reserves to remain above the 3-4 months of import coverage.

Supported by the global development, the NRBT's outlook for Tonga's economic growth remains positive. Inflation is expected to remain low reflecting weak global commodity prices. The lower prices in turn support economic activities. Foreign reserves are anticipated to remain comfortably above the NRBT's minimum range of 3-4 months of imports. The banking system continued to be profitable and strong liquidity and capital positions were maintained. Credit growth is still on the rise and bank liquidity remains high.

Against this background, the existing monetary policy setting is therefore considered appropriate in the next six months. The NRBT will continue to promote prudent lending and closely monitor credit growth in light of the impact on the monetary policy targets and financial stability. The NRBT is mindful of the impact of a continued deflation. The impact of the Government's 2015/16 fiscal budget on the monetary policy targets will also be assessed. The NRBT will continue to closely monitor the country's economic developments and financial conditions to maintain internal and external monetary stability, promote financial stability and a sound and efficient financial system, to support macroeconomic stability and economic growth.

Appendix 1: Tongan Pa'anga Exchange Rates



Appendix 2: Monetary Policy Objectives

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

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

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

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

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

An adequate level of foreign reserves also minimizes volatility in the exchange rate and

provides confidence that businesses and individuals in Tonga are able to meet their foreign currency obligations. The Reserve Bank targets a level of foreign reserves equivalent to 3 to 4 months of imports.

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

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

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

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