NATIONAL RESERVE BANK OF TONGA

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Monetary Policy Statement for August 2018

At its meeting on the 20th December 2018, the National Reserve Bank of Tonga's Board of Directors approved to release its Monetary Policy Statement (MPS) for August 2018. This Statement reviews Tonga's economic growth and the Reserve Bank's conduct of monetary policy in the six months to August 2018 and its outlook.

The Reserve Bank maintained its accommodative monetary policy stance which supported the monetary policy objectives of maintaining internal and external monetary stability, promoting financial stability and a sound and efficient financial system and conducting its activities in a manner that supports macroeconomic stability and economic growth.

The Reserve Banks' nowcast for a stronger real Gross Domestic Product (GDP) growth of 3.1% in 2017/18 remains. The favorable growth is anticipated to be led by the trade, agricultural, utility, fisheries, transport & communication and ownership of dwellings sectors. Strong growth in 2017/18 is supported mainly by the implementation of infrastructure projects and ongoing housing construction projects, upgraded power supply, and improved performance in the above-mentioned sectors despite the impact of Tropical Cyclone (TC) Gita. The agricultural production further increased over the year which was attributed mainly to the favourable weather conditions resulting in better yields for squash, taro, yam, and watermelon before TC Gita struck Tonga. According to the Domestic Market Survey Report for 2017/18, the total agricultural produce available for sale at the domestic market increased when compared to 2016/17. The total agricultural export volume also rose over the year to June 2018 driven mainly by higher exported volumes of squash followed by the exports of taro and yam.

The annual headline inflation remained high over the past several months since a hike to 9.8% in March 2018, mainly driven by local prices due to the impact of Tropical Cyclone (TC) Gita on the local food supply. However, in August 2018, the annual headline inflation rate slowed to 5.7%.

Over the past six months to August 2018, the overall Overseas Exchange Transactions (OET) balance recorded a surplus of $27.0 million. This corresponds to an increase in the foreign reserves from $448.0 million in February 2018 to $475.0 million in August 2018. This was sufficient to cover 7.7 months of import of merchandise goods and services[1], which remained above the Reserve Bank's minimum of 3 months of import. The level of foreign reserves is expected to remain at comfortable levels well above the minimum of 3 months of import cover supported by expected higher receipts of budgetary support and grant funds from development partners and expected higher receipts of remittances. This will be partially offset by the projected rise in imports.

The banking system continued to remain sound. A strong capital position was maintained, supported by banks' comfortable profitability, high liquidity, and low non-performing loans. The total banks' lending reached a new high record in August 2018. Similarly, the deposits continued to rise to new heights which are in line with the increase in the foreign reserves.

The banks' total loans to deposit ratio remained below the 80% minimum loan to deposit ratio at 71.5%, compared to 74.3% in February 2018 and 75.2% in August 2017. This was attributed mainly to deposits increasing at a faster pace than the growth in loans, which indicates that there is excess liquidity and capacity for further lending by the banks. The Reserve Bank will continue to monitor the lending growth to avoid any overheating in the economy and any potential threat to financial stability.

The net credit to Government from the banking system data rose over the past six months, due to a decrease in Government deposits. The payout of the Government's TC Gita recovery assistance, the implementation of donor-funded projects and the delay in budget support receipts that was expected before June 2018 may have contributed to this lower deposits. However, net credit to the Government is anticipated to decrease in the near term as a result of expected Government budgetary support and Government grants receipts, as well as improved Government revenue collection. The Reserve Bank will closely monitor the implication of the fiscal policy measures on the monetary policy objectives.

Given the recent developments and the outlook on the monetary policy targets, the current monetary policy stance is considered appropriate in the medium term. Therefore, the Reserve Bank will maintain its current monetary policy measures in the medium term in order to encourage the utilisation of the excess liquidity in the banking system to increase lending, particularly to the growth sectors, in order to support domestic economic growth and the recovery from TC Gita, and strengthen the monetary policy

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

transmission mechanism. Furthermore, the Reserve Bank will continue to closely monitor developments in the domestic and global economy, and update its monetary policy setting to maintain internal and external monetary stability and to promote a sound and efficient financial system in order to support macroeconomic stability and economic growth.

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