NATIONAL RESERVE BANK OF TONGA

Monetary Policy Statement

February 2018

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List of abbreviations

AUD	Australian Dollar
BSP	Bank of South Pacific
EXIM	Export-Import
EU	European Union
FEDs	Foreign Exchange Dealers
GDP	Gross Domestic Product
IMF	International Monetary Fund
MAFF	Ministry of Agriculture, Food & Forests
MPS	Monetary Policy Statement
MSMEs	Micro Small and Medium Enterprises
NBFIs	Non-Bank Financial Institutions
NEER	Nominal Effective Exchange Rate
NRBT	National Reserve Bank of Tonga
NZD	New Zealand Dollar
OET	Overseas Exchange Transactions
OPEC	Organization of the Petroleum Exporting Countries
RBA	Reserve Bank of Australia
RBNZ	Reserve Bank of New Zealand
REER	Real Effective Exchange Rate
RFB	Retirement Fund Board
ROA	Return on Assets
ROE	Return on Equity
RSE	Regional Seasonal Employees
TC	Tropical Cyclone
TOP	Tongan Pa'anga
UK	United Kingdom
US	United States
USD	United States Dollar
WEO	World Economic Outlook

Overview

Recent Development

The Reserve Bank's monetary policy objectives were observed during the past six months to February 2018 and for that reason the Reserve Bank maintained its current monetary policy stance. Inflationary pressure eased in February 2018, foreign reserves remained at comfortable levels above the minimum range of 3 – 4 months of import cover and exchange rates remained competitive. The stability of the financial system was maintained with no signs of overheating despite the strong credit growth over the year and excess liquidity remains in the financial system. Overall, the domestic economy experienced favorable growth as projected.

The Statistics Department has released its preliminary estimates of Real Gross Domestic Product (GDP) growth for 2016/17 of 5.0%. This is the highest growth for Tonga since 1998/99 and is also the fourth year of consecutive growth. This strong growth was largely driven by the industrial and services sectors and it is much higher than the growth forecasted by the Reserve Bank and the IMF of 3.7% and 3.6% respectively.

Inflationary pressures eased in February 2018, falling below the Reserve Bank's 5% reference rate. This was the lowest headline inflation since it started rising in July 2016 when the new custom duties and excise taxes were introduced. Additionally, the rise in global oil and food prices, seasonality of local food, and shortage of kava-Tonga supply drove the annual headline inflation to high level.

The overall Overseas Exchange Transactions (OET) balance for the past six months to February 2018 recorded a surplus of $43.0 million, leading to the increase in the official foreign reserves from $405.0 million to $448.0 million. This surplus was 57.0% ($15.6 million) higher than the surplus recorded for the last six months to August 2017 due to surpluses in all the three accounts with the highest contribution from the capital account.

The level of official foreign reserves at the end of February 2018 was sufficient to cover 8.1 months of import of merchandise goods and services, which remained above the Reserve Bank's minimum range of 3-4 months of import. In year ended terms, the gross official foreign reserves rose by $70.3 million. The increase over the year was due mainly to higher remittance receipts, higher receipts of foreign aid from donor partners and budgetary support for the Government.

The banking system continued to remain sound over the 6 months to February 2018. Banks maintained a strong capital position which was supported by their comfortable profitability, high liquidity, and low level of non-performing loans. Total lending maintained consistent growth and reached a new record high in February 2018. Deposits climbed to new heights also which coincided with the high level of foreign reserves. Meanwhile, the weighted average interest rate spread widened over the period.

Liquidity in the banking system (reserve money) continued to increase over the last 6 months to February 2018 by $14.8 million (5.2%) to $297.6 million which was supported by the increase in the Statutory Required Deposit (SRD) requirement that was effective in July 2017. During the past 6 months, liquidity reached a new high level of $300.7 million in November 2017. Higher deposits over the past 6 months further supported the growth in reserve money. Broad money rose over the last 6 months to February 2018 by $5.9 million (1.1%) to $558.2 million compared to $552.3 million in August 2017. This was driven by net foreign assets which increased by $39.1 million offsetting a $33.1 million decline in net domestic assets. Higher foreign reserves (with contribution from receipt of Tropical Cyclone (TC) Gita relief funds in February 2018) continued to drive the rise in net foreign assets while the increase in deposits drove the fall in net domestic assets. Broad money reached a new record high of $560.6 million in December 2017. This ratio continued to remain below the 80% minimum requirement for loan to deposit ratio which indicates excess liquidity in the banking system remains and that there is capacity for further lending by the banks.

Banking system data shows the net credit to government continued to decline by $53.2 million (47.5%) over the 6 months to February 2018, compared to a $17.2 million (18.2%) decline in the 6 months to August 2017. This stemmed from the increase in government deposits during the past 6 months to February 2018.

The Reserve Bank continued its financial inclusion initiatives to promote access to financial services and provide further protection to the consumers through regulating the non-bank financial institutions. Three legislations were passed by Parliament for the regulation of microfinance institutions, money lenders and foreign exchange dealers and await royal assent.

Outlook

Tonga's economic performance for 2017/18 remain positive despite the devastation caused by TC Gita in February 2018. The outlook for the real GDP growth for 2017/18 has been revised downward from 4.0% to 3.1% due to the lowering of the projected growth in the trade, agricultural, utility, fisheries, transport & communication and ownership of dwellings sectors.

The Reserve Bank expects the inflationary pressure to remain in the near term, due to the impact of TC Gita on the domestic food supply, and to fall below the Reserve Bank's inflation reference rate of 5% per annum at the end of 2018. The movements in global food and oil prices may pose a risk to this outlook. Additionally, the vulnerability of Tonga to natural disasters poses a risk to the local food prices and consequently the inflation outlook. The Reserve Bank will closely monitor the sources of higher inflation which include assessing the effects of exchange rates, new tax introduced and also the businesses' profit margins.

The level of foreign reserves is expected to remain at comfortable levels well above the minimum range of 3-4 months of import cover supported by expected higher receipts of remittances and foreign aid. This will be partially offset by the projected rise in imports and the commencement of the Government's principal loan repayment to the EXIM Bank of China.

The Reserve Bank's credit growth forecast for 2017/18 was revised upwards to 16% from 15% as published in the August 2017 Monetary Policy Statements (MPS), and is lower than the IMF Article IV projection of 16.6% for 2017/18. The banks cyclone relief packages are expected to support further credit growth. In addition, the excess liquidity in the banking system remains indicating there is capacity for further lending by banks hence supporting banks' efforts to support customers borrowing to recover from the cyclone. The Reserve Bank will continue to closely monitor the credit growth and broad money developments to ensure financial and macroeconomic stability are maintained and that there is no overheating in the economy. Non-performing loans is also likely to decline in the near future.

Net credit to the government is also expected to fall due to anticipated budgetary support and government grants receipts, as well as improved government revenue collection. However, this will be partially offset by the commencement of the Government's repayments of loan principal amount to EXIM Bank of China and the projected expenditure in the government's 2018/19 budget statement, which is due to be released in June 2018. The Reserve Bank will closely monitor the implication of the fiscal policy measures on the monetary policy objectives.

In light of the above 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 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 recovery from TC Gita, and strengthen the monetary policy 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.

Sione Ngongo Kioa
Governor

1. Global Developments

World Growth

The IMF in its April 2018 World Economic Outlook (WEO) reported that global economic growth has been favorable since the last IMF WEO in October 2017. This resulted from a rebound in global investment and trade in the second half of 2017. Consequently, global growth was 3.8% in 2017 which is higher than the forecasted 3.6%, meanwhile, the global growth forecast for 2018 has been revised upwards to 3.9% (from 3.7%) for 2018 and 2019. These forecasts are also supported by the recent strong momentum in growth, favorable market sentiment, accommodative financial conditions, and the domestic and international impacts of the expansionary fiscal policy in the United States (US).

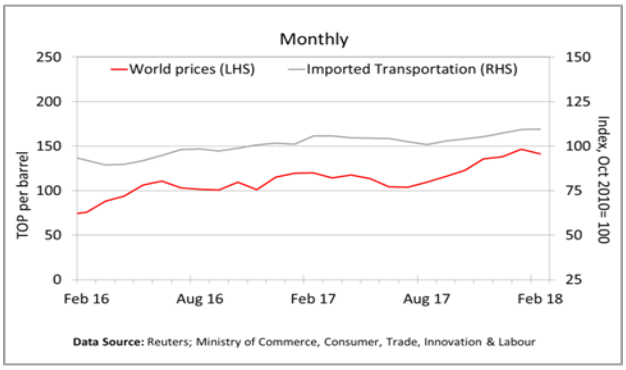
Furthermore, advanced economies experienced an investment recovery while strong growth continued in emerging Asia. Emerging Europe experienced a notable improvement in growth whereas several commodity exporters noted signs of recovery. As such, commodity prices increased according to the IMF's Primary Commodities Price Index which recorded a 16.9% rise over the 6 months to February 2018. This included an increase in fuel prices which includes oil prices.

The recent rise in commodity prices had an upward pressure on global headline inflation. Core inflation, however, remained low and stayed below the central banks' targets in most advanced economies. The monetary policy stance in most advanced economies remained broadly unchanged since the IMF October 2017 WEO. However, some advanced economies, such as the US, tightened its monetary policy by raising interest rates due to emerging signs of strengthening inflation.

World Oil Prices

According to Reuters, world oil prices averaged around US$66.13 per barrel in February 2018. This is an increase compared to August 2017 where prices averaged around US$51.87 per barrel. This is also higher than an average of US$55.99 per barrel a year ago. Oil prices are at its highest since 2015 resulting from a reduction in supply production. This stems from the extension of the production agreement by the Organization of the Petroleum Exporting Countries (OPEC) in November 2017. The agreement entails a limit on the barrels produced per day and is extended to the end of 2018.

Figure 1: World Oil prices



In addition, supply was cut unexpectedly in the US Gulf Coast (in Venezuela and other locations). Although non-OPEC supply was slightly stronger than expected in 2017, the sharp decline in production in Venezuela more than offset the increase in the non-OPEC production. Libya's production increased dramatically in 2017 yet the recent power outage in conjunction with the one in the North Sea further reduced global oil supply. Hurricane damage to infrastructure in Texas and Florida slowed the US production. However, the IMF April 2018 WEO suggests that oil prices are expected to average at US$62.3 per barrel in 2018 and US$58.2 per barrel in 2019. This is due to an expected increase of US supply and the eventual end of the OPEC deal.

Advanced Economies

The IMF April 2018 WEO reports that the U.S. GDP recorded an annual growth of 2.3% at the end of 2017 as forecasted in the last WEO release. This was fueled mainly by strong household consumption as a result of the tax cut package by government, and the U.S. economy near full employment. GDP growth is forecasted to rise further to 2.9% for 2018 and 2.7% in 2019. This is supported by expansionary fiscal policy and a firming labor market. Inflation in the U.S. recorded a rise of 2.1% for 2017 driven by increased housing costs and significantly high public demand for personal items. This had led to the tightening of monetary policy thus increase in interest rates by the Federal Reserve in February 2018. Inflation is expected to rise further to 2.5% in 2018 and 2.4% in 2019 backed by the current fiscal stimulus and the economy moving towards full employment. The US Federal Reserve in its statement in March 2018 stated that the monetary policy stance is still accommodative with the upward revision of 25 basis points to the Fed interest rate which is now at 1.75% and is expected to increase again in June 2018.

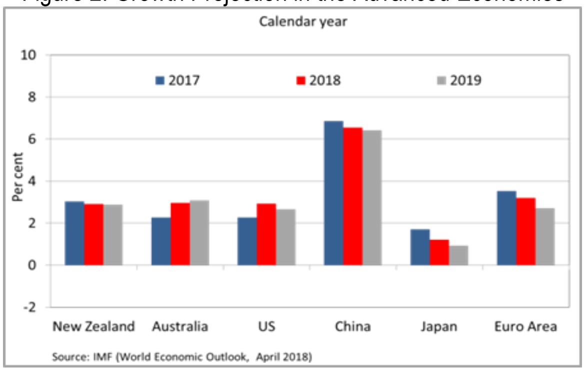
The Reserve Bank of Australia (RBA) reported in its May 2018 MPS that economic growth for Australia picked up in the most recent March 2018 quarter. This was due to a recovery in coal exports whilst liquefied gas (LNG) exports increased further. However, an annual GDP growth rate of 2.4% was recorded for December 2017 following revisions to previous MPS releases. This resulted from stronger growth in business investment and resilient growth in household consumption and public spending. Looking ahead, the outlook for growth in Australia was upgraded and is expecting a 3.3% GDP growth for 2018 and 2019. This is driven by more mining investments and expectations for sustained growth in household income and consumption, and non-mining business investment. Headline inflation was reported to have remained low and stable, recording a 1.9% rise over the year to December 2017. This was due to low wages growth and ongoing downward pressure on retail prices due to increased competition in the sector. Inflation is expected to be 2.3% by the end of 2018 and of 2019. The forecast reflects expectations of wage growth rising in response to tight labour markets and recovering oil prices. Taking into consideration the most recent developments and forecasts, the RBA Board continued to maintain its cash rate unchanged at 1.5%.

The Reserve Bank of New Zealand (RBNZ) stated in its February 2018 MPS that New Zealand experienced subdued growth in the last half of 2017. Statistics New Zealand released the official annual GDP growth of 2.9% as at the end of December 2017, which was lower than a 3.1% growth for the same period of last year. Growth for 2017 was driven by improvements in the service industries, however, tempered by the falls in the primary sector. Poor weather conditions over the second half of 2017 affected dairy production. However, GDP growth is expected to strengthen, supported by the accommodative monetary policy, high terms of trade, government spending and population growth. As such, GDP growth is forecasted to average at 3.2% over the next three years. The annual headline inflation was 1.6% for December 2017, which was weaker than the RBNZ's forecast yet higher than the 1.3% recorded in the same period last year. This is still within the RBNZ's target range of 1-3%. The latest annual inflation rate was a result of higher oil and food prices. Headline inflation is projected to increase to 1.8% at the end of 2018 and 2019 before settling at 2.0% in 2020, which is within the RBNZ's target range of 1-3%. Ultimately, the RBNZ left its official cash rate unchanged at 1.75% to support economic growth and the rising capacity pressure from strong population growth.

In the United Kingdom (UK), the IMF April 2018 WEO reported that the annual GDP growth for 2017 was 1.8%, which was slightly lower than the 1.9% growth in 2016. This resulted from recovery in exports and manufacturing yet partially offset by the decline in construction activities and imports. GDP growth is projected to slow to 1.6% in 2018 and 1.5% in 2019. This is backed by expectations for business investment to weaken in light of the uncertainty regarding post-Brexit arrangements. These forecasts are broadly unchanged compared to the IMF October 2017 WEO and stems from the anticipated high barriers to trade and low foreign direct investment which still remains in place. The Pound's depreciation weighed on household consumption activity and further led to softer growth. This also contributed to the headline inflation rate increasing to 2.7% in 2017. Headline inflation is expected to be 2.7% as well in 2018 as the impact of the Pound's depreciation keep inflation in the UK above the Bank of England's target of 2%. However, these temporary developments are expected to fade and inflation should moderate in the medium term.

The IMF April 2018 WEO reported a 2.3% GDP growth in 2017 for the Euro Area. This is stronger than the anticipated 2.1% growth reported in the IMF October 2017 WEO. Growth in 2017 was fueled by resilient private consumption, stronger global growth, and falling unemployment. The recovery in GDP growth in the Euro Area is projected to pick up to 2.4% in 2018 before moderating to 2.0% in 2019. This forecast is higher than what was reported in the IMF October 2017 WEO reflecting stronger than expected domestic demand across the Euro Area, the accommodative monetary policy and improved external demand prospects. Euro Area economies are set to narrow excess capacity with support from the accommodative monetary policy and short-term rates are projected to remain negative in the Euro Area until mid-2019. Inflation was 1.5% in 2017 as forecasted and stemmed from higher energy prices as well as the recovery in demand. Headline inflation is projected to remain at 1.5% in 2018 and rise to 1.6% in 2019 before gradually approaching the European Central Bank's target objective of about 2% by 2021.

Figure 2: Growth Projection in the Advanced Economies



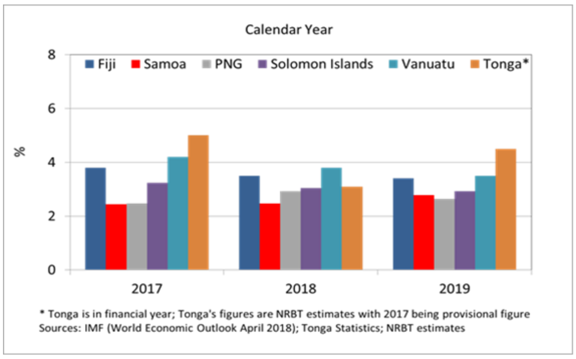
The IMF April 2018 WEO reported that China's GDP growth was 6.9%, which was higher than the forecasted 6.8% in the last WEO. This was a result of fiscal policy supporting short-term growth and lagging impacts of strong credit growth. China's economic growth is forecasted to be 6.6% for 2018 (revised upwards from 6.5%) and 6.4% for 2019. This reflects an improved external demand outlook coupled with rebalancing away from investment toward private consumption and from industry to services. Headline inflation grew at a slower pace than expected at 1.6% in 2017 due to decline in food prices. However, headline inflation in China is expected to pick up to 2.5% (up from previous forecast of 2.4%) in 2018 and 2.6% in 2019. This will still remain below the Government's target to hold the CPI at around 3.0%.

Japan's economy grew by 1.7% in 2017 as reported by the IMF's April 2018 WEO and was higher than the forecasted 1.5% growth reported in the IMF October 2017 WEO. This was due to strong business investment from high global demand for technological products and consumption. However, Japan's GDP is forecasted to slow to 1.2% (up from the previous forecast of 0.7%) in 2018 and further to 0.9% in 2019. These forecasts are owing to more favorable external demand prospects, rising private investment, and the supplementary budget for 2018. Japan's medium-term prospects, however, remained weak as a result of a shrinking labour force. Headline inflation was 0.5% in 2017 (higher than the forecasted 0.1% in the last WEO) due to higher fuel and utility prices. Headline inflation is expected to increase to 1.1% in 2018 and 2019 due to higher energy and food prices coupled with strong domestic demand. Furthermore, inflation is likely to remain below the Bank of Japan's target of 2%.

South Pacific Economies

The South Pacific region showed an average GDP growth of about 3.3% in 2017 up from the 2.9% as reported in the August 2017 MPS. Expectations for growth across the economies continued to remain moderate whilst inflation is expected to continue rising driven by the higher crude oil prices and the appreciating US dollar (which is the intervention currency).

Figure 3: Growth Projections in the Pacific



The Reserve Bank of Fiji stated in its February 2018 economic review, that Fiji's economic performances for 2017 were mixed but generally positive. This was underpinned by an increase in tourist arrivals and higher lending to the tertiary sector. However, lower projection of 3.2% (from 3.6% projected in October 2017) for 2018 is primarily a result of the devastative

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

	Real GDP growth (%)			Inflation (%)			Unemployment* (%)		
	2017	2018f	2019f	2017	2018f	2019f	2017	2018f	2019f
World Growth	3.8	3.9	3.9						
Australia	2.4	3.3	3.3	1.9	2.3	2.3	5.5	5.5	5.3
China	6.9	6.6	6.4	1.6	2.5	2.6	4.0	4.0	4.0
Euro Area	2.3	2.4	2.0	1.5	1.5	1.6	9.1	8.4	8.1
Japan	1.7	1.2	0.9	0.5	1.1	1.1	3.1	2.9	2.9
New Zealand	2.9	3.2	3.2	1.6	1.8	1.8	4.9	4.4	4.3
United Kingdom	1.8	1.6	1.5	2.7	2.7	2.2	4.4	4.4	4.5
United States	2.3	2.9	2.7	2.1	2.5	2.4	4.9	4.4	4.1

Note: f – forecast

Source: IMF (World Economic Outlook, April 2018), NRBT , RBA May 2018 MPS, RBNZ February 2018 MPS

effects of TC Josie and Keni in early April 2018, mainly on the agricultural sector. The growth outlook for 2019 has been revised upwards to 3.4% from the 3.2% as previously published. The Central Bank of Samoa reported in its MPS for 2017/18 that the economy grew by 2.4% in 2016/17 due mainly to growth in sectors such as Commerce, Agriculture and Personal & Other Services. The economic growth for 2017/18 is anticipated to slow to 1.9%. The Bank of Papua New Guinea in its 2018 MPS projected economic growth to increase by 2.2% in 2017 and is expecting further growth in 2018 and 2019 fueled by investment and tourism.

2. Tonga's Economic Growth

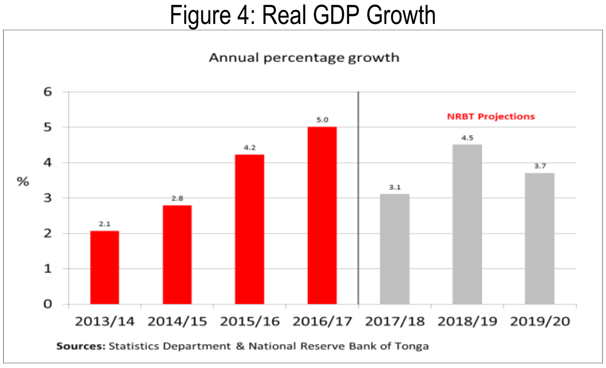
Real GDP Growth

The Statistics Department has released its preliminary estimate of Real GDP growth for 2016/17 of 5.0%. This is the highest growth for Tonga since 1998/99 and is also the fourth year of consecutive growth. This strong growth was largely driven by the industrial and services sectors. Almost all sectors of the economy recorded positive growth except for fisheries, forestry, and public administration. The Real GDP growth for 2014/15 was revised downward from 3.7% to 2.8% whilst the year 2015/16 was revised upward from 3.4% to 4.2%. The adjustment for 2014/15 was due to downward revisions to growth in the mining & quarrying and construction sectors. The upward revision to the real GDP growth of 2015/16 stemmed from higher growth for the secondary and tertiary industries.

Tonga's economic performance for 2017/18 remain positive despite the devastation caused by TC Gita in February 2018. The Real GDP growth for 2017/18 has been revised downward from 4.0% to 3.1% due to downward revision to growth in the trade, agricultural, utility, fisheries, transport & communication and ownership of dwellings sectors. This is due to the effect of TC Gita and revenue loss from respective sectors.

It is expected that the reconstruction and recovery works particularly on the sectors mentioned above including the construction sector would contribute to the economic growth of 2018/19 and spillover to subsequent financial years. Hence, the outlook for the 2018/19 has been revised upward from 2.9% to 4.5%.

Figure 4: Real GDP Growth



The upward revision to the Reserve Bank's growth outlook for 2018/19 was due to the expected increase in domestic activities as a result of the recovery and reconstruction works after TC Gita. The construction sector is anticipated to be the main driver of growth. Almost all other sectors of the economy are also expected to reflect growth and contribute to the projected high growth of 4.5%. Following the predicted high growth in 2018/19, the Reserve Bank estimated the 2019/20 growth rate to slow to 3.7%. This is due mainly to the anticipated completion of reconstruction works from TC Gita.

Primary Production

The primary sector recovered from a 2.7% decline in 2014/15 to a 0.5% growth in 2015/16 and grew further by 1.3% in 2016/17. The agricultural sector was the main driver of growth in 2016/17, which grew by 1.6% and continued to be the highest contributor of 14.8% to the overall GDP. Both agricultural and local market produce increased throughout 2016/17. However, the fishing and forestry sectors reflected a decline in real GDP by 0.1% and 0.6% respectively. The 2017/18 growth for primary sector was revised downward from 2.6% to 1.2% as an adverse effect of TC Gita. Growth in the agricultural and fisheries sectors were revised downward. Meanwhile, the growth forecast for the forestry sector increased. This was supported by more firewood available after the cyclone and the increase in demand for electric poles for the restoration works for electricity after the cyclone.

The agricultural sector is expected to have a slower growth of 1.0% in 2017/18 compared to the anticipated growth of 2.5% in 2016/17. This is a downward revision from the 2.0% growth published in the August 2017 MPS. The expected growth is supported by favorable weather during the first half of the financial year which resulted in an increase in both domestic production and export volume. During the first eight months of 2017/18, the total volume of agricultural exports increased by 1,616.8 tonnes (18.1%) to a total 10,537.2 tonnes. This was supported by a better season for fruit products such as squash and coconuts, and harvest of root crops such as taro and yam.

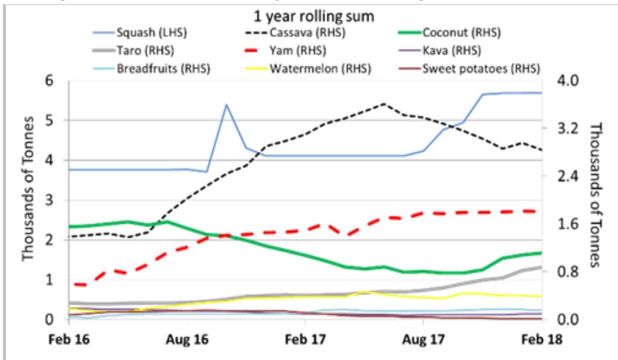
Table 2: Real GDP Growth Forecast

	Revised Official 2014/15	Revised 2015/16	Preliminary 2016/17	FY 2017/18 (Aug-17 MPS) %	FY 2017/18 (Revised) %	FY 2018/19 (Aug-17 MPS) %	FY 2018/19 (Revised) %	FY 2019/20 %
GDP	2.9	4.2	5.0	4.0	3.1	2.9	4.5	3.7
Primary production	**-2.7**	**0.5**	**1.3**	**2.6**	**1.2**	**2.1**	**2.2**	**2.0**
Agriculture	-4.8	-0.4	1.6	2.0	1.0	1.8	2.0	2.0
Forestry	16.8	-20.2	-0.6	0.1	2.0	0.1	2.0	0.5
Fishing	7.4	8.9	-0.1	5.7	2.0	3.5	3.5	2.0
Secondary production	**7.0**	**9.7**	**11.1**	**7.7**	**7.5**	**4.1**	**10.0**	**7.2**
Mining and quarrying	-15.3	-20.3	16.5	7.5	5.0	4.0	7.0	5.0
Manufacturing	4.2	1.3	3.8	5.0	6.0	2.8	3.0	3.0
Utilities	2.1	9.2	8.9	5.5	2.0	4.0	7.0	5.0
Construction	14.0	19.2	16.4	10.0	10.0	5.0	15.0	10.0
Tertiary production	**2.7**	**4.7**	**3.4**	**3.1**	**2.0**	**2.8**	**3.1**	**2.8**
Trade	4.4	11.0	7.7	4.5	2.0	3.8	4.0	4.0
Hotels, restaurants	7.7	7.2	3.7	2.6	1.5	2.8	2.0	2.0
Transport, communication	12.4	0.0	8.7	3.5	2.0	4.1	4.0	4.0
Financial intermediation	-3.9	12.6	1.5	7.0	7.5	6.5	7.0	5.0
Real estate, business services	6.4	6.7	7.3	2.0	1.0	2.0	2.0	2.0
Public administration	1.7	0.4	-1.7	1.0	1.0	1.0	1.0	1.0
Education	-2.8	-3.1	8.2	2.0	1.0	2.0	2.0	2.0
Health and social work	-7.9	8.6	0.0	1.5	2.0	1.5	1.5	1.5
Recreational, cultural activities	6.7	5.1	0.0	3.0	1.0	2.0	2.0	2.0
Other community services	-6.3	19.5	2.2	2.0	2.0	1.5	1.5	1.5
Ownership of dwellings	1.0	0.1	0.6	3.0	0.5	1.0	3.0	2.0
Other*	5.2	6.7	7.9	1.0	1.0	1.0	1.0	1.0

* Includes taxes minus subsidies and imputed bank service charges
Source: Department of Statistics, NRBT

Squash exports in late 2017 contributed largely to this rise with the total squash export volume increasing by 1,575.6 tonnes (38.3%), followed by an increase of 404.7 tonnes (123.2%) in exported taro.

Figure 5: Volumes of Major Exported Agricultural Exports



Source: Ministry of Agriculture, Food and Forests.

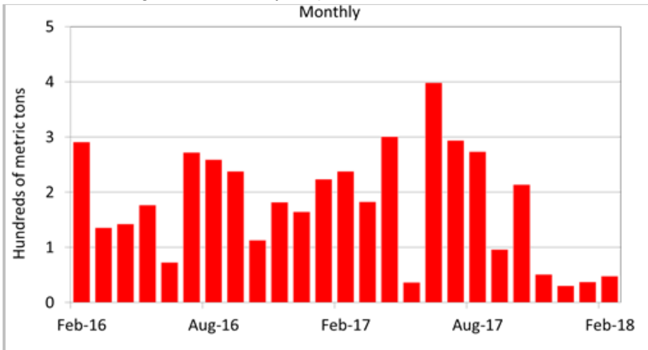
In addition, crops that were sold domestically rose by 1,396.5 tonnes (68.6%) during the first eight months of 2017/18. Almost all crops available in the domestic agricultural market increased led by watermelon, coconuts, cassava and yam. The Government Development Loan scheme also supported growth in the agricultural sector by providing affordable loans to growers and agricultural exporters.

However, the agricultural export proceeds reported by the banking system for the first 8 months of 2017/18 declined by $2.1 million (22.1%) to $7.4 million. The lower export receipts was due to less receipts for the substantial squash exported during the first eight months of 2017/18. Liaison with the Ministry of Agriculture Food & Forestry (MAFF) confirmed that the Japanese local supply of squash was adequate for the market hence the price for imported squash, including the squash supply from Tonga, was low, particularly when most of the prices are spot market price rather than fixed market price.

The recovery works following TC Gita is expected to yield a strong growth of 2.0% in both 2017/18 and 2019/20 for the agricultural sector. This is supported by continuous support from the MAFF which includes distributing planting material and seedlings such as root crops cuttings and vegetables seedlings to growers in Tongatapu and 'Eua. Additionally, the Reserve Bank's liaison program found farmers to be optimistic on their path to recovery to increase production so they are able to cover losses that were incurred as a result of the cyclone. However, the greatest risk to the outlook of this sector is the uncertainty in the weather conditions and the sustainability of land after being farmed continuously.

The strong growth projected for the fisheries sector prior to the cyclone was based on various initiatives and incentives from the Ministry of Fisheries to improve the sector. However, damages to fishing vessels and fish fences are expected to affect fishing activities and production. Additionally, one of the pearl farms located in Pangaimotu was completely damaged as reported by the Ministry of Fisheries. Hence, the estimated growth for 2017/18 was revised downward from 5.7% to 2.0%. In the first eight months of 2017/18, the volume of marine exports (excluding aquarium products) declined by 647.0 metric tons (38.2%). This was due to a fall in exported tuna by 634.4 metric tons (41.0%) in addition to lower number of registered fishing boats in the past 8 months compared to the same period in 2016/17. However, aquarium exports increased by 8,052 pieces (9.9%) driven by the rise in exported invertebrates. For the same period, total fisheries and other marine products export proceeds declined by $1.8 million (31.1%) which coincided with the decline in the exported volume of fish.

Figure 6: Fishery Exports



Source: Ministry of Fisheries.

The outlook for 2018/19 remained unchanged at 3.5%, as repairing of fishing boats and fish fences are expected to be completed by the beginning of 2018/19 and will continue operations to increase output in the sector. In addition, the continued facilitation of different initiatives by the Ministry of Fisheries and other incentives to implement the Tonga's Fisheries Sector Plan will improve the sector. This includes the plan of marketing and farming of pearls in both Vava'u and Ha'apai. This sector continued to benefit from the duty exemptions on oil and fishing gear and the initiatives of

Fisheries Development and Export Fund (FDEF) by the Government through its GDL scheme to support access to finance of fishermen. Growth is expected to continue into 2019/20 at 2.0%. Nonetheless, weather uncertainties still remain a risk to this sector.

A growth of 0.1% was projected in the August 2017 MPS for 2017/18 and 2018/19 for the forestry sector. The Reserve Bank has increased the growth forecast by 1.9 percentage points for both 2017/18 and 2018/19. A 2.0% real GDP growth is expected for these two consecutive financial years before reverting to a slower growth of 0.5% in 2019/20. Firewood is used as one of the proxy indicators for this sector and sellers of firewood in the local market had indicated plentiful supply of firewood after the cyclone.

In addition, Tonga Power Limited had scheduled major network upgrade projects in Tongatapu and Vava'u in 2017/18 which will continue to 2018/19, together with the restoration of electricity after the cyclone. This will require more than 9,000 electric poles thus the demand for poles supplied by Aotearoa-Tonga Forest Product Limited (A-TFP) will increase contributing to the growth in the forestry sector. However, the competition from overseas firms may put pressure on domestic supplier as A-TFP had signed a two year contract with Samoa to also provide electric poles. MAFF has also planned to revive the sandalwood market overseas which will further contribute to growth in this sector in the long term.

Secondary Production

The industrial sector continued to record strong growth for the fourth consecutive year. 2016/17 recorded strong growth of 11.1% following growths of 9.7% in 2015/16 and 7.0% in 2014/15. The main driver of growth was the construction sector with 16.4% growth in 2016/17, which has a 7.5% share of GDP. Growth in previous years for the construction sector was revised to 19.2% in 2015/16 and 14.0% in 2014/15. Major construction projects completed during the year such as Government buildings and private housing and private non-residential constructions contributed to growth in 2016/17. Growth in the utility, manufacturing, mining & quarry sectors also increased.

Growth in the industrial sector for 2017/18 was slightly revised downward to 7.4% from 7.7% as a result of losses caused by TC Gita in the utilities and mining & quarry sectors. Moreover, the reconstruction works that are expected to take place in 2018/19 will raise the forecasted growth to 10.0% before slowing to 7.2% in 2019/20.

The construction sector's forecasted growth for 2017/18 remained unchanged at 10.0% as reported in the August 2017 MPS supported by the increase in business loans for construction. Although the projects scheduled to be implemented in the 2017/18 such as the construction of sports facilities such as the Tonga High School (THS) Sports Complex and the relocation of Tonga Side School and other projects, were delayed. The renovations of cyclone affected buildings (schools, homes, offices) will offset these delayed construction projects. Some major projects completed during the year included the Costlow shopping center, the Taufa'ahau Tupou IV Wharf and the Tailulu multi-million hall, to name a few.

The demand for housing renovations and new constructions is expected to increase however this depends on individuals' financial capacity. Loan to construction businesses increased by $1.3 million in the 6 months to February 2018 and is expected to increase further in preparation for the reconstructions after the cyclone. Payouts by insurance companies to some affected businesses and households would contribute to boost reconstruction activities in the second half of 2017/18 and in 2018/19.

The construction sector is projected to grow by 15.0% in 2018/19 and 10.0% in 2019/20 as a result of the reconstruction works and delayed projects from 2017/18. These include the new office building for the Utilities sector, Customs Office building and various other private construction works which are expected to drive growth in the upcoming years. The developments in the construction sector are expected to have spillover effects on mining and quarrying activities, manufacturing, utilities sector and other sectors of the economy. The number of existing houses decreased due to the destruction caused by the cyclone, however it would be partially outweighed by new constructions that were completed during the financial year. On the outlook for ownership of dwellings, the reconstruction works would increase the number of houses to the level it once had.

After two financial years of negative growth in the mining & quarrying sector, 2016/17 recorded a high growth of 16.5% driven mainly by the strong growth in the construction sector. Developments in the mining & quarrying sector are expected to be in line with the projected vibrant construction sector. Eight months into 2017/18 had seen loans to the mining & quarrying sector increasing to $1.1 million from $0.4 million in the same period of 2016/17. Growth for 2017/18 is expected to be around 5.0% and to follow by a further 7.0% growth in 2018/19.

The damages to the utilities sector particularly the damages to the power infrastructure led to a downward revision of growth from 5.5% to 2.0% in 2017/18. This is reflected in lower electricity production of 0.37 million kW in the first eight months of 2017/18 compared to first eight months of 2016/17. However, electricity production rose by 1.44 million kW and the number of electricity consumers rose by 549 during the first 7 months of 2017/18. Given the expected developments in the construction sector, the utilities sector is also forecasted to grow further by 7.0% in 2018/19. The movements in the global oil price is also expected to impact growth in the utilities sector.

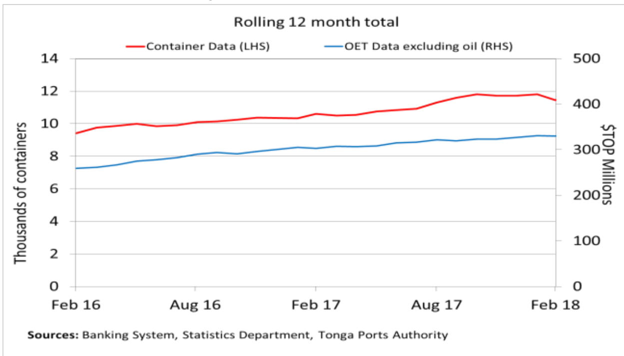
A strong 6.0% growth in the manufacturing sector is expected in 2017/18. This is an upward revision from 5.0% reported in the August 2017 MPS. The demand for manufactured goods such as water bottles and plastic water tanks, cement & concrete and hardware manufacturing materials are likely to have increased after the cyclone which benefits the manufacturing businesses. A slower growth of 3.0% is anticipated for 2018/19 supported by lower demand for manufactured goods related to the completion of the anticipated constructions works.

Tertiary Production

The growth recorded in the tertiary sector for 2016/17 was 3.4%, as all sectors in this industry grew except for public administration. Growth in real terms for 2015/16 was revised upward from 3.7% to 4.7% due to higher revisions to the trade and community services sectors. Growth projections for 2017/18 however, was revised downward to 2.0% from 3.1% due to the disruptions caused by TC Gita on activities in the trade, tourism, transportation & communication, real estate and ownership of dwellings sectors.

Damages caused by TC Gita to trade activities had reduced the expected growth in the trade sector to 2.0% from 4.5%. Eight months into 2017/18 and the container registrations increased by 615 registrations (8.8%). Both business and private containers rose by 12.3% and 4.8% respectively. The celebrations and events held during the year and the increase in private constructions supported this growth. However, the number of registered vehicles declined by 41 registrations (1.7%) in the first eight months of 2017/18 due to the disruptions caused by TC Gita as people were more attentive on repairing of their homes which were damaged or destroyed.

Figure 7: Import Indicators



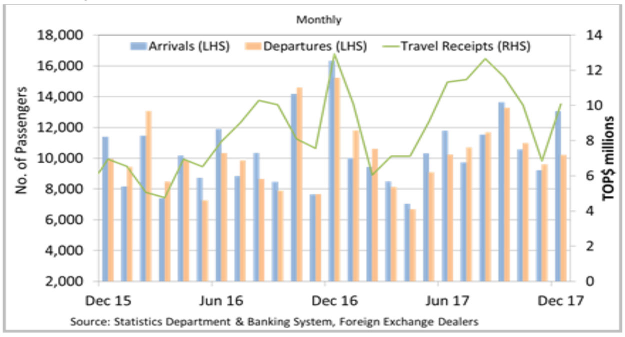
Sources: Banking System, Statistics Department, Tonga Ports Authority

The Reserve Bank expects imports and consequently container registrations to generally increase in the near term. This is supported by the in-kind donations from developing partners, Non-Government Organisations and Tongans from abroad to assist the cyclone recovery. The Reserve Bank's liaisons with the construction and transport sectors had indicated growing demand in these sectors which will also drive imports in the near future. Construction works are anticipated to contribute to the rise. Spillover effects on the trade, tourism, construction sectors and other sectors in the economy are also anticipated.

Minimal damage were reported from the port as well as the airport runways and both were in full operation within a week after the cyclone. However, damages in the communication industry after the cyclone is expected to reduce growth in the sector to 2.0%. The improvement in the forecasted growth in the transport sector stems from the new road constructions under the Climate Change Resilience Project.

TC Gita is expected to slow down growth in the tourism sector for 2017/18 to 1.5% from the previously forecasted 2.6% growth. During the first half of 2017/18, international air arrival visitors rose by 4,991 passengers (14.4%). The number of returning residents, on the other hand, rose by 1,629 passengers (9.3%). Travel receipts in the first half of 2017/18 was in line with the increase in total arrivals which increased by $4.8 million (8.2%). It is expected that most resorts, hotels and restaurants will quickly recover and be fully operational before the main tourist season which runs from May to October. Hence, the Reserve Bank remains optimistic that the tourism sector will grow in 2018/19 by 2.0% and will continue to grow in the upcoming years.

Figure 8: International Air Arrivals & Travel Receipts



Higher credit growth continued to support activities in the financial intermediation sector. The increasing activity in this sector was sustained by the low interest rate environment and the ongoing competition among banks mainly for loans.

Growth in real terms for the financial intermediation sector was 1.5% in 2016/17. The Reserve Bank's monetary policy to encourage the utilisation of the excess liquidity in the banking system to support economic activity supports the outlook for strong lending growth. The Reserve Bank anticipates a 7.5% growth in 2017/18 and to further grow by 7.0% in 2018/19. Initiatives by banks to offer cyclone relief packages to the affected customers also supported the expectation of further growth.

Unemployment

The unemployment rate remains unchanged[1] as reported in the August 2017 MPS. According to the Reserve Bank's survey of job advertisements in the past eight months, recruitment intentions were largely observed in the public administration sector. The high number of job advertisements in the public administration sector are potential new recruitment by the Government in 2017/18 which are incorporated in respective Government Ministries' budgets. Over the year to February 2018, recruitment intentions declined by 12 job advertisements as recruitment intentions on almost all other sectors outweighed the increase in job advertisements from the public administration sector. The Reserve Bank expects the positive outlook for the economy will increase the demand for labour in the near term and thereby lower the unemployment rate.

[1] Tonga's Statistics Department published 3 different unemployment rates in its 2016 Census of Population & Housing.

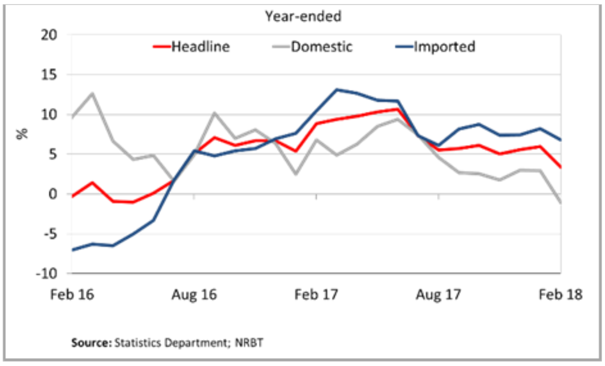
1. 1.1% - Not working, available & looking for work
2. 16.4% - Not working, available & willing to work
3. 34.8% - including subsistence workers

3. Promoting Low and Stable Inflation

Recent Developments

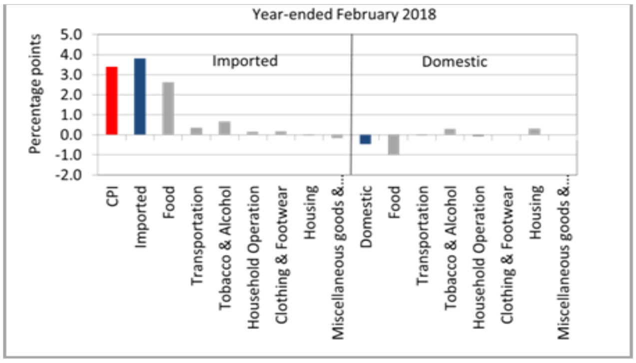
Inflationary pressures eased in February 2018, falling below the Reserve Bank's 5% reference rate. This was the lowest level for headline inflation since it started rising in July 2016 when new custom duties and excise taxes was introduced. Coupled with the rise in global oil and food prices, seasonality of local food, and shortage of kava-Tonga supply drove the annual headline inflation higher.

Figure 9: Inflation



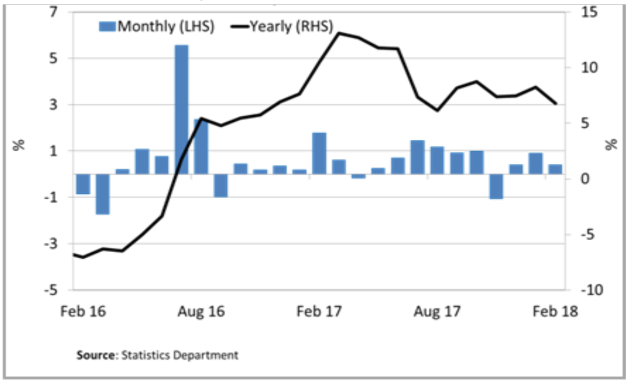
The annual headline inflation was 3.4% in February 2018 compared to 8.9% in February 2017 and 5.5% in August 2017. This was solely driven by a 6.8% rise in imported commodities which outweighed an annual decline in domestic prices. The lower headline inflation in February 2018 was driven by a fall in local food and electricity prices which outweighed the annual rise in kava-Tonga and housing prices.

Figure 10: Contributions to Inflation



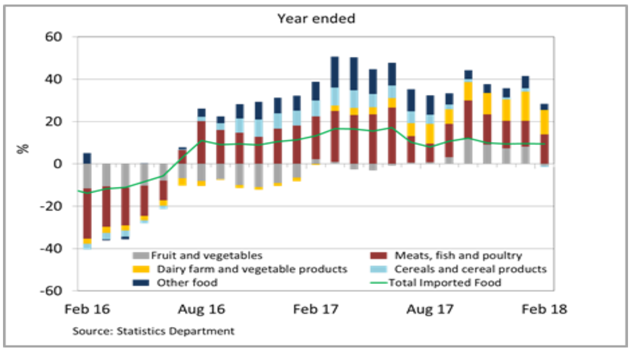
Imported inflation starting rising in July 2016 and peaked at 13.2% in March 2017. In February 2018, the annual imported inflation increased by 6.8% driven by the increased prices of almost all imported commodities which contributed 3.8 percentage points to the overall headline inflation. Imported food price was the lead contributor, rising by 9.4% and contributed 2.6 percentage points to the annual imported inflation. The meat, fish & poultry category had the highest increase of 14.1%, followed by an 11.4% increase in the price of dairy products, and 2.9% rise in other food components which comprises of items such as sugar and flour. Movements in the global price of meat and poultry coupled with the changes in customs duties and excise taxes on meat products were driving prices higher. This was reflected in the increased prices of chicken pieces and lamb flaps which rose by 16.5% and 15.5% respectively over the year.

Figure 11: Imported Inflation



Additionally, the second highest driver of imported inflation was the price of tobacco which rose by 16.4% and contributed 0.6 to the annual change of imported inflation. Higher tobacco price was partly driven by the increase in excise tax on tobacco which was introduced in July 2017. This is evident in the 18.7% rise in the price of Winfield blue over the year to February 2018. Other imported goods which rose over the year included petroleum prices for petrol, diesel, kerosene and liquid petroleum gas.

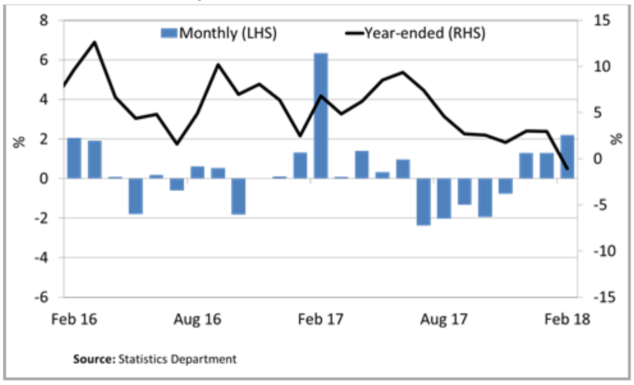
Figure 12: Imported Food



Fuel prices rose by 4.7% over the year to February 2018, contributing 0.4 percentage points to the annual headline inflation. The prices of diesel and petrol rose over the year by 7.2% and 4.3% respectively. The high fuel prices were due to higher world oil prices which flow through to local oil prices with a lag of 1-2 months. In February 2017, the Brent crude oil was US$56.07 per barrel compared to US$66.48 (18.6%) in February 2018.

However, the domestic prices declined by 1.1% over the year to February 2018. The local supply of fruits and vegetables was favorable during the month of February 2018 in comparison to its season in February 2017. Hence, the price of fruits and vegetables declined by 11.9% which outweighed the annual rise in prices of meat, fish, and cereal products. Additionally, electricity price declined over the year by 2.2% amongst other goods such as communication and transportation (inter-island ferries).

Figure 13: Domestic Inflation

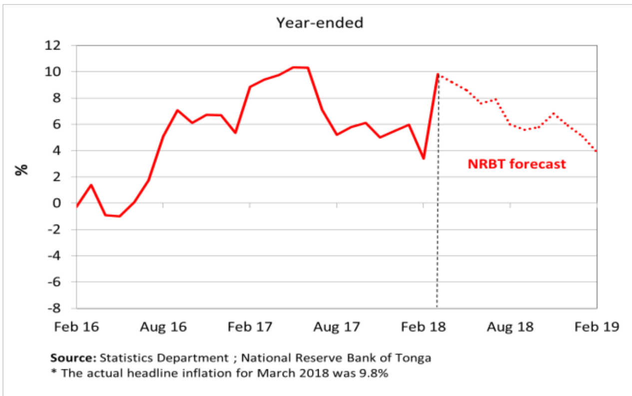


These outweighed the rise in the prices of goods and services for house maintenance, and local alcohol and kava-Tonga. Therefore, the overall decline in domestic prices has partially offset the increase in imported prices annually by 0.5 percentage points.

Outlook

The Reserve Bank expects the inflationary pressure to remain in the near term due to the impact of TC Gita on the domestic food supply, and is expected to fall below the Reserve Bank's inflation reference rate of 5% per annum by the end of 2018. The movements in global food and oil prices may pose a risk to this outlook. Additionally, the vulnerability of Tonga to natural disasters poses a risk to the local food prices and consequently the inflation outlook. The Reserve Bank will closely monitor the sources of higher inflation which include assessing the effects of exchange rates, new tax introduced and also the businesses' profit margins.

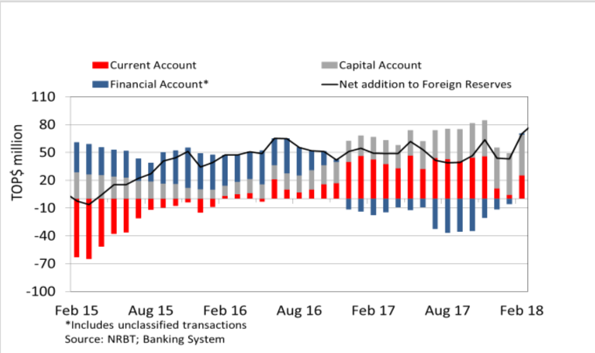
Figure 14: Headline Inflation Forecast



4. Maintaining Adequate Level of Foreign Reserves

The Reserve Bank continued to closely monitor the country's external monetary position in its function to maintain an adequate level of foreign reserves above 3-4 months of import cover. Based on Overseas Exchange Transactions (OET) data collected by the Reserve Bank from banks and authorised restricted foreign exchange dealers (FEDs), the Reserve Bank has therefore calculated an estimate of the balance of payments.

Figure 15: Balance of Overseas Exchange Transactions



Balance of Overseas Exchange Transactions

The overall OET balance for the past six months to February 2018 was a surplus of $43.0 million, leading to a rise in the official foreign reserves from $405.0 million to $448.0 million. This surplus was 57.0% ($15.6 million) higher than the surplus recorded for the last six months to August 2017, and was contributed by the surpluses in all the three accounts. Capital account recorded the highest surplus, followed by the surpluses in the financial account and the current account.

Over the year to February 2018, the overall OET balance also recorded a surplus of $70.3 million, which was 43.1% higher than the surplus of $49.1 million recorded in the year ended February 2017. Similarly, all three accounts recorded surpluses and the capital account again contributed the highest surplus.

Current Account

Over the six months to February 2018, the balance of the current account was a surplus of $9.3 million, compared to a surplus of $16.0 million in the last six months to August 2017. The current account receipts specifically the official transfer receipts were much lower compared to the last 6 months, which largely contributed to the lower surplus in the current account.

In year ended terms, the current account balance recorded a surplus of $25.4 million compared to a surplus of $42.4 million in the year ended February 2017. The current account payments mostly imports and primary income payments increased at a faster rate than the rise in the current account receipts driven by private remittances and telecommunication services over the year.

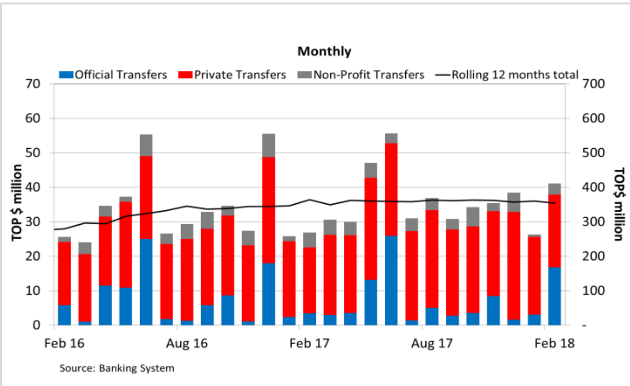
Current Account Receipts

➢ *Transfer*

Transfer receipts accounted for the largest share in the current account receipts at around 53%. In the past six months to February 2018, the transfer receipts fell by $25.0 million due to decreases in all categories. Despite the receipt of $16.7 million in grants for the TC Gita relief fund, the official transfer receipts declined the most by $16.0 million (30.8%) due to lower receipts of budgetary support and government grants during the period. Private transfer receipts followed with a decline of $6.6 million (4.2%) and it was mainly due to a decrease in receipts for family support. The receipts for non-profit transfer also decreased by $2.5 million (10.8%) which was attributed mainly to lower grants received by non-profit organizations mostly churches and schools for technical assistance and other current expenditure.

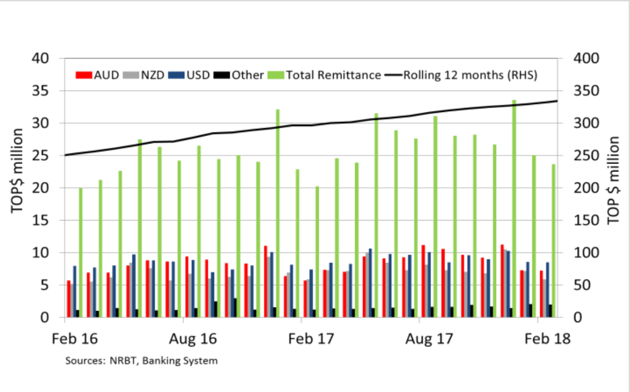
Over the year to February 2018, the total transfer receipts rose by 6.6% to $437.0 million which was contributed mainly by the rise in private transfer receipts more than offsetting the decline in receipts of official and non-profit transfers.

Figure 16: Transfer Receipts



Over the six months to February 2018, the total remittance receipts slightly declined to $165.2 million. 90.7% were private transfer receipts with a total of $149.8 million and were mostly gifts and family support funds from families and relatives abroad. The receipts for the compensation of employees (seasonal employees and other wages and salaries) followed with a total of $9.5 million (5.7%). Private capital transfers by individuals totaled to $5.5 million (3.3%) and social benefits were $0.4 million (0.3%). Although the impact of de-risking has resulted in challenges in retaining of some of the FED's bank accounts, the total remittances continued to hold the biggest share (42.5%) of the total OET receipts and the majority (88%) continued to be channeled via FEDs. Over the year to February 2018, total remittances rose by 12.1% to $332.5 million, and accounted for 42% of the total OET receipts. Higher remittances were due mainly to an increase of transfers from families and friends abroad to support their families. This was mainly for supporting of families who were affected by TC Gita and also cater for major celebrations throughout the year such as family reunions and churches' annual conferences, and individual constructions. It is estimated that remittances as a share of GDP will remain above 35%.

Figure 17: Remittances by Currency



- *Export*

Over the six months to February 2018, the total export proceeds slightly rose by $0.8 million (7.7%) to $10.6 million. The proceeds from the export of agricultural products increased and partially offset a decline in the proceeds from marine and other exports. The higher proceeds from agricultural exports reflected the harvesting season of squash while unfavorable weather conditions resulted in the decline in the exported volume of fish contributed to the lower marines & other export receipts. In the year ended February 2018, the total export proceeds declined by $2.0 million (8.8%) to $20.4 million. This was due mainly to lower proceeds from agricultural exports of $1.9 million and marine exports of $1.6 million. Other exports proceeds, on the other hand, rose by $1.5 million.

- *Services*

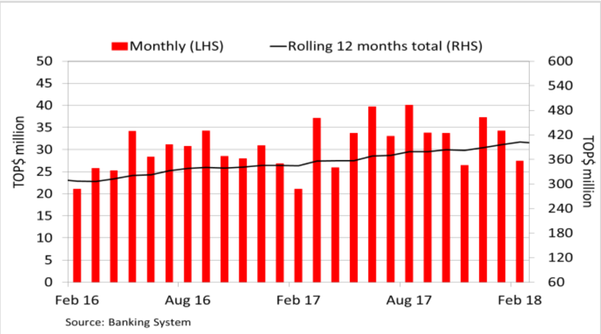
Service receipts for the six months to February 2018 slightly rose by $0.1 million. An increase in insurance receipts which included $7.7 million in insurance claims from the TC Gita damages in February 2018 and a $2.5 million rise in transport receipts mainly for postal and courier services outweighed a $10.3 million drop in receipts from other private services, mainly telecommunication services, as well as the decline in travel receipts. In contrary, the total service receipts increased over the year to February 2018 by 20.0% ($32.6 million) to $195.3 million which stemmed from higher telecommunication and travel receipts.

Current Account Payments

- *Imports*

The total current account payments declined by $15.8 million to $315.0 million over the six months to February 2018 mainly due to lower import and primary income payments. All categories of import payments decreased except for wholesale and retail import payments. Other imported goods, mostly the Government's imports declined the most by $11.2 million, followed by a $9.6 million decrease in payments for the import of construction materials. Payments for oil and vehicle imports fell by $8.0 million and $1.2 million respectively. On the other hand, the payments for wholesale and retail imports rose by $13.3 million. The decline in payments for construction goods coincided with the decrease in new housing loan commitments of 34.7% over the six months to February 2018 compared with the previous 6 months.

Figure 18: Import payments



In year ended terms, the import payments however rose by $57.7 million (16.7%) to $402.5 million, driven mainly by a $70.6 million rise in payments for the import of wholesale and retail goods followed by a $30.8 million increase in oil import payments. Government import payments also rose by $9.3 million while payments for construction materials and motor vehicles fell by $9.2 million and $0.2 million respectively. The rise in the import of wholesale and retail goods supported a 7.9% increase in container registrations and the improved growth in the trade sector.

- *Primary Income payments*

Primary income payments fell over the six months to February 2018 by $7.8 million but increased in year ended terms by $12.3 million largely reflecting the payments of dividend to non-resident shareholders.

➢ *Services & Transfer payments*

Over the six months to February 2018, both services and transfer payments increased. Service payments rose by $3.6 million due to higher freight payments and transfer payments increased by $5.0 million due to an increase in official transfer payments. Over the year to February 2018, both service and transfer payments slightly rose by $0.6 million and $1.4 million respectively. Higher service payments was attributed to higher payments for personal travel together with higher payments for sea transport and insurance premiums. The increase in payments for official transfer purposes drove the rise in transfer payments which reflect the reimbursement of unspent funds from projects funded by development partners.

Capital Account

Over the six months to February 2018, the capital account receipts rose by $7.1 million to $27.5 million, driven by higher private capital receipts for investment projects or capital expenditures. The capital account payments also rose by $3.7 million, driven by both rises in private capital and official capital payments for investment projects or capital expenditures for construction purposes by individuals and Government. This resulted in a capital account surplus of $23.6 million for the period.

The capital account surplus for the year ended February 2018 rose from $24.1 million to $43.9 million, resulting from surpluses in both the official and private capital accounts. The surpluses in both accounts were due mainly to higher receipts in both accounts outweighing the higher payments made on both accounts. Higher foreign aid funds received by the Government for investment projects and capital expenditures drove the higher receipts of official capital and higher receipts by private companies and individuals for investment projects and capital expenditures drove the higher private capital receipts.

Financial Account

Over the six months to February 2018, the balance in the financial account recorded a surplus of $16.2 million, declining by 14.0% from a surplus of $18.8 million in the past six months to August 2017. This was attributed mainly to higher net payments from direct investment outweighing net receipts from other investments. Direct investment payments were mainly repayments of intercompany funds while other investment receipts were mainly interbank receipts.

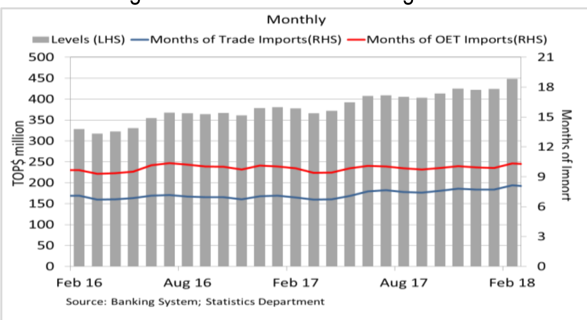
Over the year ended February 2018, the financial account also recorded a lower surplus of $35.1 million, a decline of $40.0 million (53.3%) from the surplus of $75.0 million in the year ended February 2017, reflecting a decline in foreign direct investment.

The balance of unclassified transactions recorded an average outflow of $2.8 million per month over the 12 months to February 2018, compared to $7.7 million in the previous year. This was due to lower financial claims by non-residents which involves foreign exchange dealings between commercial banks and their overseas correspondent banks.

Official Foreign Reserves

The official foreign reserves peaked at a new high record of $448.0 million in February 2018, compared to $405.0 million in August 2017. This was sufficient to cover 8.1 months of import of merchandise goods and services[2], which remained above the Reserve Bank's minimum range of 3-4 months of import. In year ended terms, gross official foreign reserves rose by $70.3 million. The increase over the year was due mainly to higher remittance receipts, higher receipt of foreign aid from donor partners and budgetary support for the Government.

Figure 19: Gross Official Foreign Reserves



Exchange Rates

Over the six months to February 2018, the TOP depreciated against all major currencies except AUD. This led to a decline in the Nominal Effective Exchange Rate (NEER) index by 1.6% while the Real Effective Exchange Rate (REER) index rose by 0.3%, reflecting the impact of Tonga's higher inflation relative to its major trading partners. In year ended terms, the NEER index fell by 1.5% while the REER index rose by 0.9%.

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

Outlook

The Reserve Bank expects the level of foreign reserves to remain comfortably above the minimum range of 3-4 months of import up to June 2018 based on the following key factors:

- Remittances are expected to remain at high levels over the coming months due to upcoming festivities and scheduled events for 2018 such as the annual church conferences and school anniversaries. Rising number of people joining the RSE schemes also contributes to expectation of higher remittance receipts. Private transfers from friends and relatives abroad to their families in Tonga to support recovery from TC Gita will also contribute to the expected higher remittance receipts.
- Expected growth in the agricultural and fisheries activities is expected to boost export proceeds and this will be offset by the projected rise in import payments.
- Banks and foreign exchange dealers are expanding their range of products and services offered to customers such as opening of agents in the outer islands as well as extending services in their overseas agents which will also support remittances and other financial receipts.
- Tourism activities such as whale watching, proceeds from artisanal handicrafts, sea cruises and more airline routes are expected to support positive travel receipts.
- Government receipt of aid funds in the form of budget support and other assistance from donor partners are expected in the next financial year for on-going construction projects and recovery from damages caused by TC Gita.

Risks to the outlook of the foreign reserves include the following:

- Delays to the inflow of aid and budget support from development partners combined with the pace of development in domestic economic activities pose a risk to the foreign reserves outlook.
- The significant rise in external debt service to Export - Import (EXIM) Bank of China as the principal repayment of the loan commences in financial year 2018/19.
- Uncertainty in the commodity prices can harm Tonga's external position as a price taker.
- Vulnerability to natural disasters also remain a risk.

5. Promoting a Stable Financial System

The banking system continued to remain sound over the 6 months to February 2018. Banks maintained a strong capital position which was supported by their comfortable profitability, high liquidity, and low level of non-performing loans. Total lending maintained consistent growth and reached a new record high in February 2018. Deposits climbed to new heights also which coincided with the high level of foreign reserves. Meanwhile, the weighted average interest rate spread widened over the period.

Table 3: Consolidated Balance Sheet of Depository Corporations

	Level			YoY change	
	Feb 17 $TOPm	Aug 17 $TOPm	Feb 18 $TOPm	Feb 17 $TOPm	%
Broad money liabilities	**510.2**	**552.3**	**558.2**	**48.0**	**9.4**
Currency in circulation	50.9	60.7	65.8	14.9	29.3
Demand deposits	200.7	200.0	181.8	-18.8	-9.4
Savings and Term deposits*	258.6	291.6	310.5	51.9	20.1
Equals					
Net foreign assets	**402.2**	**429.0**	**468.1**	**65.9**	**16.4**
Plus					
Net domestic assets	**108.3**	**123.4**	**90.3**	**-17.9**	**-16.6**
Gross bank lending**	394.6	427.0	442.9	48.2	12.2
Other***	-286.4	-303.6	-352.5	-66.2	23.1

* Also includes very minor amounts for securities other than shares.
** Differs slightly from standard measures of bank lending by amounts classified as accrued interest.
*** Includes mostly capital accounts of the banks and NRBT, and their net claims on the central government.
Note: Figures may not be exactly the same as in the text below and table above due to rounding errors.
Sources: Banking system; NRBT

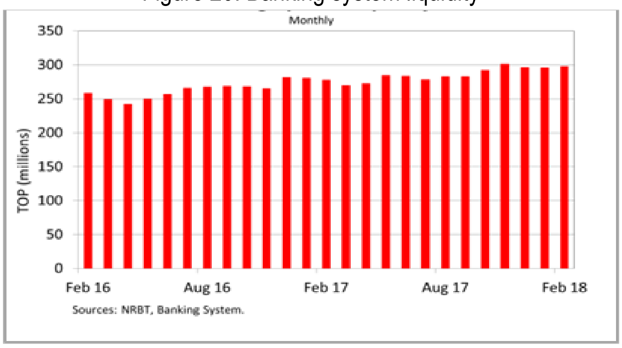
Money Supply

Broad money rose over the last 6 months to February 2018 by $5.9 million (1.1%) to $558.2 million compared to $552.3 million in August 2017. This was driven solely by net foreign assets which increased by $39.1 million offsetting a $33.1 million decline in net domestic assets. Higher foreign reserves, with contribution from the receipt of TC Gita relief funds in February 2018, continued to drive the rise in net foreign assets while the increase in deposits drove the fall in net domestic assets. Broad money reached a new record high of $560.6 million in December 2017.

Over the year to February 2018, broad money increased by $48.0 million (9.4%). This resulted from a rise of $65.9 million in the net foreign assets offsetting a $17.9 million decline in net domestic assets. This is the highest annual growth recorded for net foreign assets which is line with the consistent increase in the foreign reserves. Furthermore, this coincided with the $20.5 million (31.8%) rise in currency in circulation and a $52.0 million (25.7%) increase in term deposits. The Reserve Bank continued its efforts to improve the quality of banknotes and coins in circulation and at the same time meet public demand and the commercial banks' demand for certain denomination of banknotes and coins. The Reserve Bank's Currency Department continued to direct deposits of mint quality notes to the Reserve Bank's note trust depots in the outer islands by interchanging and replacing mutilated notes with good quality notes on a timely manner.

Liquidity in the banking system (reserve money) increased over the last 6 months to February 2018 by $14.8 million (5.2%) to $297.6 million and is higher than the level of $282.9 million reported in the August 2017 MPS. During the past 6 months, liquidity reached a new high level of $300.7 million in November 2017. Higher deposits over the past 6 months further supported the growth in reserve money. Additionally, liquidity in the banking system rose over the year to February 2018 by $19.7 million (7.1%). This was a result of an increase in currency in circulation and the Statutory Required Deposits (SRD).

Figure 20: Banking system liquidity



The banks' total loans to deposit ratio (including Government Development Loan scheme) increased in February 2018 to 76.2% from 75.2% in August 2017 and from 73.3% in February 2017. This reflects the continued strong growth in lending. This ratio continued to remain below the 80% minimum loan to deposit ratio which indicates excess liquidity in the banking system remains and that there is capacity for further lending by banks. The Reserve Bank will continue to monitor the lending growth to avoid any overheating in the economy.

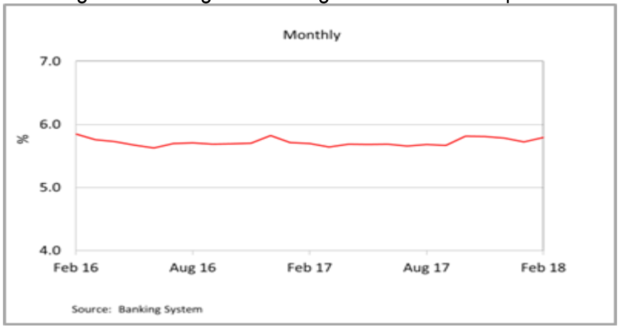
Interest Rates

The weighted average lending rate increased by 12.4 basis points (from 7.83% to 7.95%) which outweighed the increase in the weighted average deposit rate of 1.3 basis points (from 2.15% to 2.16%) over the past 6 months to February 2018. Consequently, the banks' weighted average interest rate spread widened by 11.1 basis points to 5.79% from 5.68% in August 2017. The weighted average lending rate rose over the past 6 months due to higher business lending rates mainly for lending to the agricultural, manufacturing, and construction sectors. The increase in the weighted average deposit rate was a result of the rise in the volume of deposits rather than an increase in particular categories of deposit rates.

Over the year, the weighted average lending rate increased by 9.6 basis points whilst the weighted average deposit rate remained relatively stable. As a result, the weighted average interest rate spread widened by 9.6 basis points. The weighted average lending rate rose due to higher lending rates for both households and businesses. Lending rates for housing and other personal loans led the rise in lending rates for households whilst higher lending rates for the agricultural, fisheries, and construction sectors drove the higher lending rates for businesses.

However, the low interest rates on GDL scheme facilitated by the Tonga Development Bank contributed to retaining of relatively low weighted average lending rates particularly for the manufacturing, tourism, and forestry sectors.

Figure 21: Weighted Average Interest Rates Spread



The weighted average deposit rate remained stable over the year as respective movements across all deposit categories were relatively the same. Whilst the demand and term deposit rates declined respectively by 4.8 basis points and 12.8 basis points over the year, the saving deposit rates rose by 2.2 basis points. These developments were also supported by the consistent rise in the foreign reserves as well as the continued rise in total deposits which increased over the year to February 2018 recording a high level of $577.2 million.

Figure 22: Deposit Rates

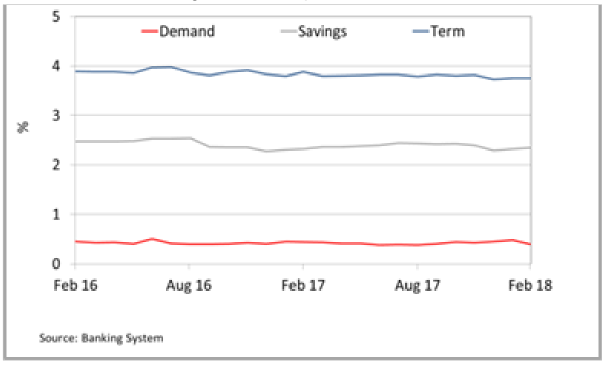


Table 4: Lending Rates

Weighted average of all banks

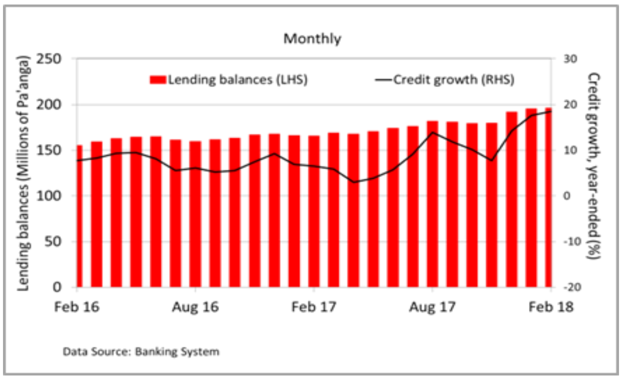
	Level as at			Change over 6 months to		Loan share	
	Feb 18	**Aug 17**	**Feb 17**	**Feb 18**	**Aug 17**	**Feb 18**	**Aug 17**
	%p.a.	**%p.a.**	**%p.a.**	**Bps**	**Bps**	%	%
All	7.95	7.83	7.86	12.4	- 2.8	100	100
Housing	8.10	8.10	8.01	- 0.1	9.4	43	43
Other personal	11.34	10.97	10.97	36.9	0.5	13	13
Business*	7.05	6.82	6.90	23.2	- 8.4	28	28
Other	6.25	6.54	6.25	- 28.9	28.9	12	12

*Included Statutory Non-financial Corporation and Other Financial Corporations

Lending

Total banks' lending (including GDL) increased over the past 6 months to February 2018 and over the year to a new high level of $439.5 million. Total loans increased by $23.9 million (5.8%) in the 6 months to February 2018, which was lower than the $31.1 million (8.1%) rise in the 6 months to August 2017. Total lending rose as a result of a $14.3 million (7.8%) and $10.0 million (4.3%) increase respectively for lending to businesses and households. Only 1.9% of total loans were funded from the GDL as at the end of February 2018, slightly decreasing from 2.2% in August 2017.

Figure 23: Business Lending (including GDL)

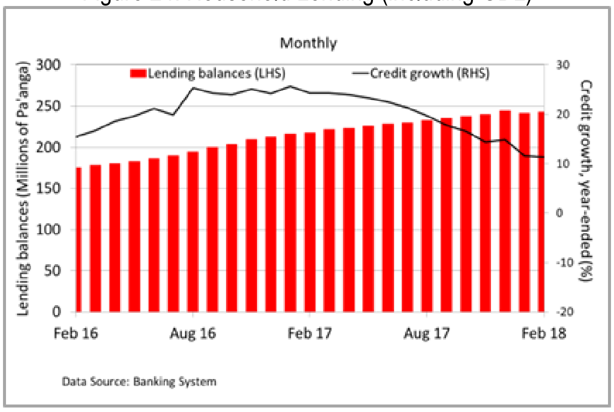


Banks' lending to businesses (including GDL) increased over the past 6 months to $196.1 million, compared with $181.8 million in August 2017. This was largely a result of higher lending to the wholesale & retail, tourism, and fisheries sectors. This continued to coincide with the pace of economic activities within the private sector. This further indicates preparations for the festive season, church conferences, family reunions, and other on-going developments over the six months to February 2018. Activities in the private sector continued to expand. New business buildings were constructed and renovations took place, including the completion of new extension of the Friends Café Center, Cost Low Supermarket, Kupu House, Cowley Bakery and the Dateline Transam Shipping Warehouses. Other business developments are on-going yet to be completed such as the Kongakava Boutique Hotel. Despite the increase in the weighted average lending rate over the past 6 months, it remained relatively low which continued to support the higher level of lending to businesses. Low interest rates on GDL further supported higher lending to business sectors. Without the GDL scheme, banks' lending to businesses still increased by $15.3 million (8.8%) over the past six months.

The increase in lending (including GDL) to households was driven significantly by higher housing loans offsetting declines in vehicle and other personal loans. This continued to indicate the consistent demand for housing. Over the 6 months to February 2018, housing loans increased by $13.2 million (7.7%) and led banks' lending to households to a new record high of $242.6 million, compared to $232.6 million recorded in August 2017. The weighted average lending rate for individual housing loans remained stable which was supportive of the demand by households for housing loans. Other household personal loans decreased by $3.1 million (5.1%) whilst vehicle loans decreased by $0.1 million (10.0%). Without the GDL scheme, household loans increased by $10.0 million (4.3%) over the past six months.

New loan commitments declined over the 6 months to February 2018 by $5.5 million (38.4%) to $8.8 million. This was due to a fall in new loan commitments to both households (mainly housing and other personal loans) and businesses (mainly public enterprises, wholesale & retail, and professional services sectors).

Figure 24: Household Lending (including GDL)

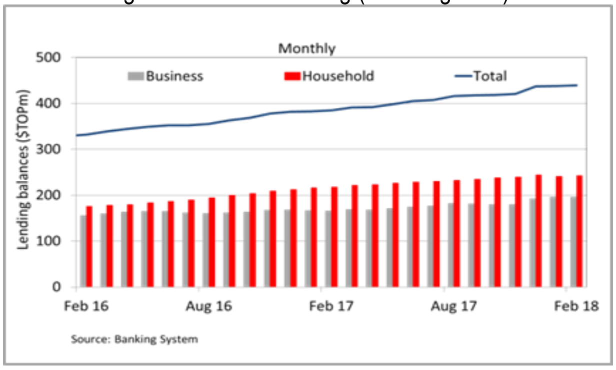


Over the year, total bank lending (including GDL) increased by $55.0 million (14.3%) which resulted from increases in lending to both businesses and households of $30.6 million (18.5%) and $24.7 million (11.3%) respectively. The yearly rise in household lending was driven by housing loans which increased by $26.6 million (16.8%) offsetting declines in vehicle and other personal loans.

Business loans increased which was driven by higher lending to the wholesale & retail, transport, tourism, and fisheries sectors. The growing activities in these sectors were partially supported by the lower interest rates from the GDL scheme.

Lending activities of the non-bank financial institutions[3] also increased over the year by $16.5 million (12.1%). Lending to household increased by $18.1 million (21.8%) offsetting a fall in Government on-lent loans.

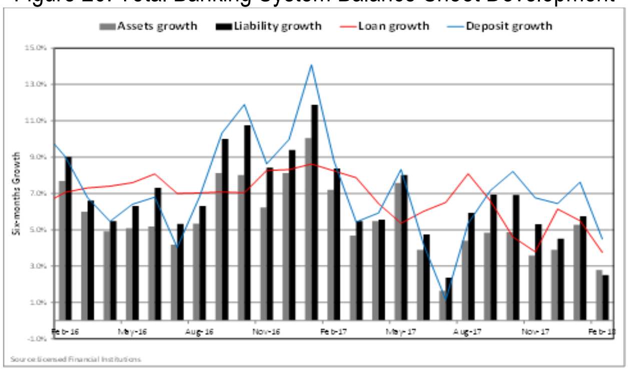
Figure 25: Bank's lending (including GDL)



Banking System Performance

The banking system remained sound during the six months to February 2018. Total assets of the banking system increased by $33.1 million (2.8%) to $809.2 million over the six months to February 2018. This was due mainly to a 3.8% ($15.6 million) growth in total loans. Similarly, total liabilities increased by 2.5% ($16 million) to $656 million which was largely attributed to a 4.5% ($24.8 million) growth in total deposits over the past six months to February 2018.

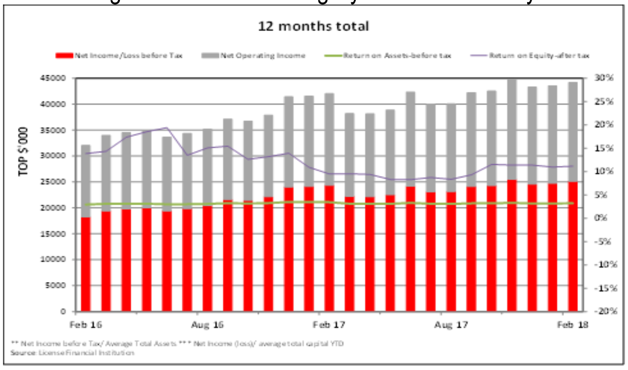
Figure 26: Total Banking System Balance Sheet Development



The total banking system remained profitable over the year to February 2018. The Net Profit After Tax was $19 million, increasing from $16.9 million in August 2017, and $17.7 million in February last year. The main reasons that drove the increase in net profit after tax was the increase in interest income from the continuous growth in banks' loan portfolio and the lower provisioning expenses over the year.

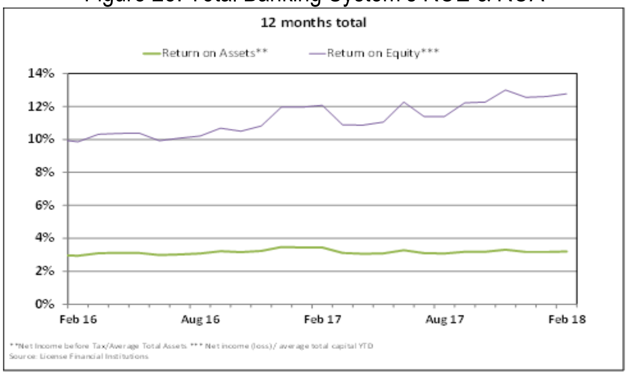
Return on Assets (ROA) and Return on Equity (ROE) increased over the past six months. The ROA was 3.2% increasing from 3.1% as profitability continued to improve. ROE also rose to 12.8% from 11.4% in August 2017 driven by higher profits.

Figure 27: Total Banking System's Profitability



The banking system's capital position remained strong as the risk-weighted capital ratio was at 30.5% in February 2018, rising from 27.9% in August 2017, and continued to remain well above the Reserve Bank's minimum requirement of 15%. The higher risk weighted capital ratio reflected the transfer of profit from the 2017 calendar year to retained earnings for all banks in January 2018. The banks' net interest margin remained stable at 3.2% from August 2017. This continued to reflect rising average assets which was mainly driven by credit growth over the six months offsetting the rise in interest income. Similarly, average total liabilities driven by deposit growth grew over the six months to February 2018 offset the rise in interest expense.

Figure 28: Total Banking System's ROE & ROA



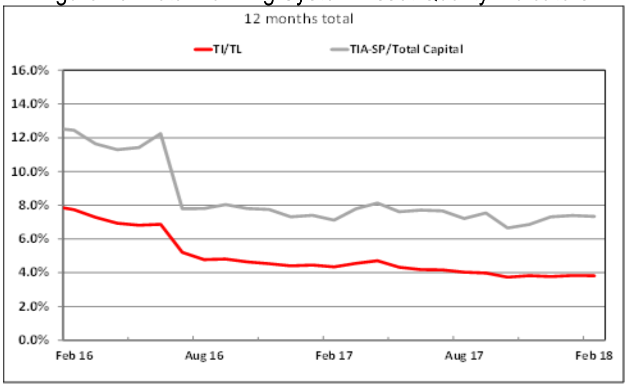
The overall quality of the banks' assets has remained relatively stable over the past six months to February 2018. Total non-performing loans remained stable at

[3] This includes SPBD, RFB & Government on-lent loans

$16.9 million, which represented 3.9% of total loans compared to 4% in August 2017 and 4.3% a year ago.

The non-performing private business loans grew to 49% of total non-performing loans, from 56% six months ago and comprised mainly of loans for Tourism, Professional and other services, Construction and Agriculture.

Figure 29: Total Banking System Asset Quality Indicators



Non-performing private individual loans accounted for 51% of total non-performing loans, which is higher than the 44% recorded in August 2017. This was attributed to the rise in non-performing housing loans for one of the small banks due to borrowers migrating overseas or going on study leave.

Provisions against loan losses fell over the last six months from $15.3 million to $14 million in February 2018 reflecting mainly the write back of specific provision as some of the non-performing loans were undergoing settlement process. The total coverage ratio which shows the capability of the banks' total provisions to cover non-performing loans fell to 86.2% from 91.6% in August 2017 but slightly rose from 86.1% in February 2017. However, the banks continued to hold sufficient collateral to cover for any shortfall in loan loss provisions.

The Reserve Bank continued to monitor and manage the payment system to ensure it is functioning in an efficient, sound and safe manner. There is ongoing review of options and opportunity to explore an automated payment system that will assist in improving the efficiency of the settlement of banks' transactions.

Outlook

The Reserve Bank's credit growth forecast for 2017/18 was revised upwards to 16% from 15% as published in the August 2017 Monetary Policy Statements (MPS), but is slightly lower than the IMF Article IV projection of 16.6% for 2017/18. The banks' TC relief packages are expected to support further credit growth. In addition, the excess liquidity in the banking system remains indicating there is capacity for further lending by banks hence supporting banks' efforts to assist customers borrowing to recover from the cyclone. At the same time, structural reforms to improve the credit environment such as improvement to the land administrative system and a bankruptcy law would improve the confidence of the banks to lend prudently. Furthermore, the continuous improvement in business confidence, improving economic conditions and on-going annual events are anticipated to support credit growth. The Reserve Bank will continue to closely monitor the credit growth and broad money movements to ensure financial and macroeconomic stability are maintained and that there is no overheating in the economy.

Broad money is also projected to increase in June 2018 by 14%, as previously projected, supported by the anticipated rise in lending and the foreign reserves. However, this growth outlook is projected to also rise in line with the upward revision in the credit growth due to TC Gita. This is higher than the IMF Article IV's projection for broad money to rise by 12.1% in June 2018.

Supervision of Non-Bank Financial Institutions (NBFIs)

The supervision and oversight of all non-bank financial institutions remains work in progress. The legislations for the supervision of money lenders, microfinance institutions and foreign exchange control have been approved by the Legislative Assembly on the 13th March 2018 and are awaiting royal assent. Other legislations that are being drafted include the legislations for the supervision of retirement funds, insurance companies, investment firms, and the capital markets. Work is in progress to develop the regulatory framework to implement the approved legislations. The Reserve Bank continues to advocate the regulation of non-bank financial institutions mainly to protect the interest of customers as well as ensure these non-bank financial institutions are conducting their operations prudently. Work is also in progress to update the stock take of all the NBFIs operating in Tonga.

The issue around de-risking and correspondent banking continued to be discussion points during meetings held over the six months to February 2018. However, no concrete solution on the impact of de-risking has been finalized as options are still being explored. The Reserve Bank continued to work together with the authorized restricted foreign exchange dealers to strengthen their Anti-Money Laundering/Counter Financing Terrorist (AML/CFT) compliance status in order for the banks to retain their accounts. The South Pacific Central Bank Governors have raised their concerns with the US regulators, the Federal Reserve Bank of New York and the US Treasury during the year. Other developments include new remittance products such as the TDB 'Ave Pa'anga Pau product, some banks reducing their remittance fees, as well as the release of the assessment by Australia's Financial Intelligence Unit (AUSTRAC) of the remittance corridor to the Pacific which has rated it low risk. Nevertheless, efforts continue to encourage the development of Fintech solutions that would enable the low cost remittance of funds and at the same time still comply with the AML/CFT requirements. The Reserve Bank participated in a study by World Bank and other studies by other agencies on the impact of de-risking in Tonga.

Non-Bank Supervision team will be conducting training in July 2018 on new reporting templates for the non-bank financial institutions. This will include reports for Insurance Companies, Foreign Exchange Dealers, Pension Funds, and Microfinance Institutions. These will be voluntary reporting until there is a specified Act for each of these Non-Banks.

Financial Inclusion Initiatives

The Reserve Bank's Financial Inclusion Unit continues to work towards achieving its ultimate goal of improving access to finance for all individuals and Micro Small Medium Enterprises (MSMEs) in Tonga. This contributes to accomplish the Bank's overall objective of stimulating inclusive economic growth and maintaining macroeconomic stability.

In the beginning of 2018, the Reserve Bank started with the reformation of the Financial Inclusion Framework to prioritise focus areas for Financial Inclusion in order to accomplish the department's objective of improving access to finance for both individuals and MSMEs in Tonga. This also recognized the potential of digital financial services as a major driver for financial inclusion in delivering the financial services to every segment of the societies including rural and remote areas, and the outer islands. As a result, the commitment of the Reserve Bank to the Alliance for Financial Inclusion (AFI) has been amended. This included the adjustment made to the Reserve Bank's Maputo Commitment from a target to improve access to finance of MSMEs by 20% in 2020 for agriculture, fisheries, and tourism sectors, and women and youth, to targeting all MSMEs in all sectors in Tonga. The focus for now is collection of data from banks and non-bank financial institutions in order to establish the baseline level of access to finance by both individuals and MSMEs and usage of financial services in Tonga, and monitor the progress in these areas.

MSMEs' Access to Finance

According to the latest available data on MSME loans, total loans to MSMEs rose by $6.7 million (56%) to $18.7 million over the year ended June 2017. This reflected an increase in the number of MSMEs that banks lend to by 85 MSMEs (5%) to a total of 1,670 MSMEs.

The increase in total MSME outstanding loans was mainly due to growths in loans to the wholesale & retail, other services and fisheries sectors. A number of factors contributed to this positive growth which included the high liquidity in the system, continuation of the Government Development Loan (GDL) scheme offering low interest rates and the launching of BSP's MSME products.

Individuals' Access to Finance

Based on the latest available data, the total access points in the banking system rose by 6% to 538 access points over the year ended June 2017. This was mainly due to an increase in the number of ATMs, bank branches and EFTPOS by 27%, 13% and 6% respectively. The rise in the number of ATMs and EFTPOS for both ANZ Bank and Bank South Pacific (BSP) mostly contributed to the increase as they expanded on their digital banking footprints. The re-opening of BSP's bank branches at Ha'apai and 'Eua also contributed to the overall rise in total access points.

The access to financial services indicators showed that for every 10,000 adults in Tonga there are 83 cash in and cash out points as of June 2017. This is an improvement compared to the benchmark of 32 access points per 10,000 adults in 2015 which highlighted the increase in the number of banks' access points.

The usage of financial services rose by 1% over the year ended to June 2017 owing to an increase in the number of loan accounts outweighing the decline in the number of deposit accounts. The fall in the number of deposit accounts reflected removal of deposit accounts that have been overdrawn for more than three months or have been dormant. The total number of loan accounts rose by 5% to 10,707 which is in line with the continued strong loan growth in the banking system. This is supported by the increase of 25% in outstanding loans to private individuals over the year ended June 2017 which coincided with lower lending rates for housing loans. The financial services usage indicators therefore reflected a decline in the number of regulated deposit account indicator by 9 deposit accounts to 10,788 per 10,000 adults whilst the number of loan accounts rose by 244 loan accounts.

Table 5: Sector Growth over the year

SECTOR CONTRIBUTION FOR 2016 - 2017								
Type of Sectors	2016				2017			
	Number of MSMEs	Outstanding Balance	MSMEs	Outstanding Balance	Number of MSMEs	Outstanding Balance	MSMEs	Outstanding Balance
TOTAL	**1,585.0**	**11,968,776.6**	**100%**	**100%**	**1,670.0**	**18,700,220.1**	**100%**	**100%**
Agriculture	762.0	3,176,969.6	48.1%	26.5%	729.0	4,389,316.4	43.7%	23.5%
Construction	15.0	943,382.9	0.9%	7.9%	23.0	1,183,470.4	1.4%	6.3%
Fisheries	47.0	224,826.9	3.0%	1.9%	69.0	1,377,974.6	4.1%	7.4%
Forestry	-	4,589.3	0.0%	0.0%	6.0	46,030.0	0.4%	0.2%
Manufacturing	395.0	2,195,847.9	24.9%	18.3%	473.0	1,229,190.5	28.3%	6.6%
Other services	298.0	1,683,981.8	18.8%	14.1%	280.0	3,335,252.6	16.8%	17.8%
Tourism	29.0	1,437,144.3	1.8%	12.0%	28.0	2,319,880.1	1.7%	12.4%
Transport	6.0	230,363.1	0.4%	1.9%	3.0	294,571.6	0.2%	1.6%
Wholesale/Retail	33.0	2,071,670.7	2.1%	17.3%	59.0	4,524,533.9	3.5%	24.2%

6. Fiscal Indicators

Over the six month to February 2018, the fiscal position remained positive despite the damages caused by TC Gita. Banking system data shows the net credit to Government continued to decline by $53.2 million (47.5%) over the 6 months to February 2018, compared to a $17.2 million (18.2%) decline in the 6 months to August 2017. This stemmed from the increase in Government deposits during the past 6 months to February 2018. The receipts of grants, project funds, insurance claims for post-cyclone Gita recovery, dividends from public enterprises and improved government revenue collection supported the growth in Government revenue during the past 6 months. In February 2018, a total of $22.6 million was received for the TC Gita relief fund from the World Bank (WB) and Asian Development Bank (ADB). In addition, the People's Republic of China (PRC) provided cash donation and the New Zealand Ministry of Foreign Affairs and Trade (MFAT) also pledged to give NZD$10 million to support the cyclone recovery particularly on the restoration of the electricity network and construction works for schools. Other in-kind donations were received from the Australian Department of Foreign Affairs and Trade (DFAT), Embassy of Japan, Republic of Korea, US aid, EU, India-United National Development and PRC to name a few.

Moreover, the amended custom duties and excise taxes which became effective on the 1st July 2017 have contributed to the higher Government revenue collected over the past 6 months.

Similarly, net credit to Government also decreased over the year by $70.4million (74.4 %), due to a $66.7 million (55.3%) rise in Government deposits. The receipt of budgetary support before the end of the 2016/17 financial year largely contributed to this increase.

The 2017/18 Government budget expected the receipt of $34.4 million in budget support from development partners, however, none has been received to date. Nevertheless, a portion of $4.7 million from the delayed budgetary support of $6.0 million from the EU that was budgeted for 2016/17 was received in August 2017. This contributed to the higher foreign reserves over the year. The budget support funds estimated for 2017/18 is expected to be received before the end of the 2017/18 financial year from the Department of Foreign Affairs and Trade (DFAT) and the Ministry of Foreign Affairs and Trade (MFAT).

The IMF in its 2017 Article IV mission staff report indicated that the Debt Sustainability Analysis (DSA) for Tonga has increased from moderate to high mainly because of future potential costs of natural disasters and Tonga's high vulnerability to natural disasters. As a result, future budget support funding that used to be 50% grant and 50% credit will now become 100% grant only. The total public debt position for June 2018 is expected to represent 52.4% of GDP, of which 46.0% is external debt and 6.4% is domestic debt. This is consistent with one of the three fiscal targets in the Government of Tonga Fiscal Strategy for 2017/18, which is to maintain the external debt below 50% of GDP. The other two targets are to raise domestic revenue collections to at least 22% of GDP and to maintain the compensation of employees at no more than 53% of domestic revenues and moving towards 50% over time. The total debt service for 2017/18 is estimated to remain at over $20 million where majority of this debt service is to finance the external loan repayments. The external debt service is projected by the Reserve Bank to remain at over $10 million for the 2017/18 financial year and to rise significantly to over $29 million in 2018/19. This is attributed to the first principal repayment for the Nuku'alofa Central Business District Reconstruction loan due in September 2018, followed by the commencement of principal repayment for the Tonga National Road Improvement Project loan in March 2020, both to EXIM Bank of China. The main repayment months for external debt are September and March of every year due to repayment of two major loans to EXIM Bank of China. The EXIM Bank of China remained the main external debt creditor and hence the Chinese Renminbi has the highest share of the total external debt portfolio. This significant increase in external debt service to EXIM Bank of China in 2018/19 is anticipated to put pressure on the level of foreign reserves.

Going forward, it is anticipated that Government receipts will increase in the near term due to the budget support that are yet to be received in 2017/18. This would contribute to the Reserve Bank's projection for foreign reserves to remain comfortably above the minimum range.

Net credit to the Government is also expected to fall due to anticipated budgetary support and Government grants receipts, as well as improved Government collection. However, this will be partially offset by the commencement of the Government's repayments of principal amount to EXIM Bank of China and the projected expenditure in the Government's 2018/19 budget statement, which is due to be released in June 2018. The Reserve Bank will closely monitor the implication of the fiscal policy measures on the monetary policy objectives.

7. Monetary Policy Stance

The Reserve Bank maintained its accommodative monetary policy stance in the last 6 months to February 2018. Inflation eased in February 2018, foreign reserves remained at comfortable levels above the minimum range of 3 – 4 months of import cover, exchange rates were competitive, the banking system remained sound with strong capital and liquidity position maintained and the domestic economy experienced favorable growth as projected. The stability of the financial system was maintained with no signs of overheating despite the strong credit growth over the year.

Excess liquidity in the banking system still remained as the continuous increase in deposits, coinciding with the higher foreign reserves, outweighed the strong credit growth. The banks' loans/deposit ratio remained below the 80% loan to deposit target. The excess liquidity in the system therefore continues to weaken the monetary policy transmission mechanism.

The growth outlook for Tonga remains positive in the years ahead. The level of foreign reserves is expected to remain at comfortable levels well above the minimum range of 3-4 months of import cover supported by expected higher receipts of remittances and foreign aid. This will be partially offset by the projected rise in imports and the commencement of the Government's principal loan repayment to the EXIM Bank of China.

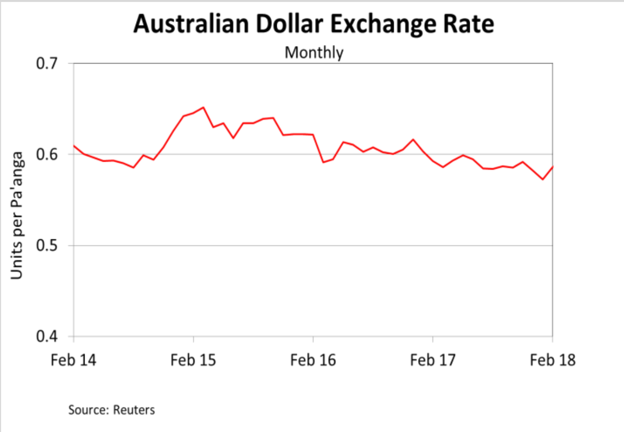
Inflation is anticipated to remain below the Reserve Bank's inflation reference rate of 5% per annum at the end of 2018.

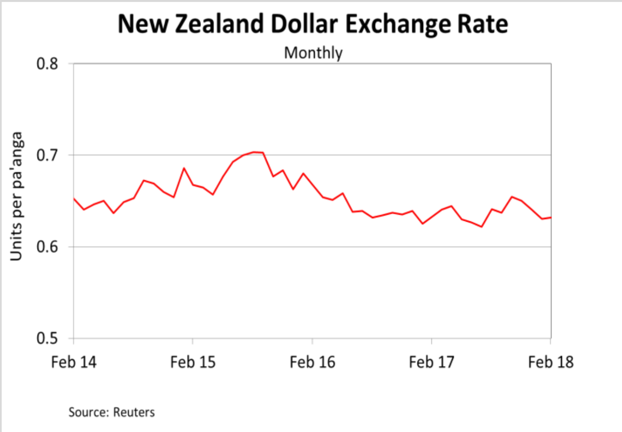
In light of the above developments and the outlook on the monetary policy targets, the current monetary policy stance is considered appropriate in the medium term. Therefore, these monetary policy measures will remain unchanged in the medium term in order to encourage the utilisation of the excess liquidity in the banking system to increase lending, particularly to the growth sectors, in order to support domestic economic growth and recovery from TC Gita, and strengthen the monetary policy transmission mechanism.

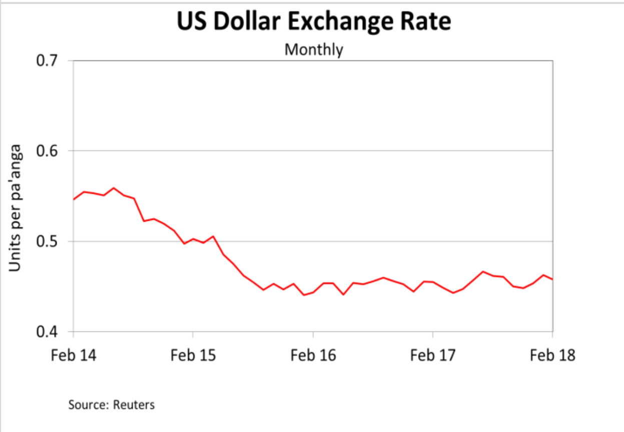
- ✓ Maintain the monetary policy rate (interest rate on banks' exchange settlement accounts or excess reserves) at 0% (zero interest rate policy);
- ✓ Maintain the minimum loans/deposit ratio at 80%;
- ✓ Maintain the Statutory Reserve Deposit ratio at 10%;
- ✓ Maintain the inflation reference rate at 5%;

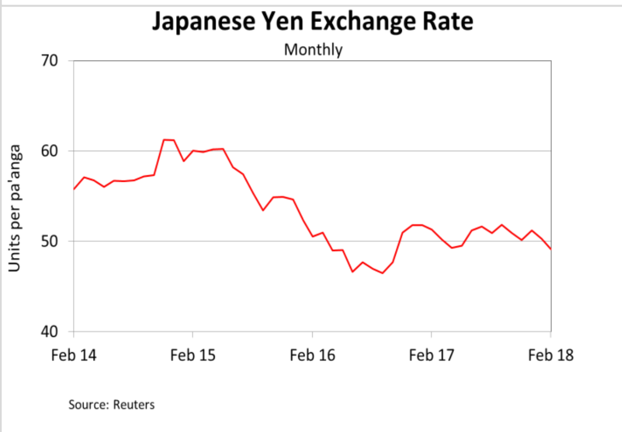
The Reserve Bank will remain vigilant and continue to closely monitor developments for early signs of vulnerabilities which may indicate overheating of the economy. Furthermore, the Reserve Bank will continue to closely monitor developments in the domestic and global economy, and update its monetary 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.

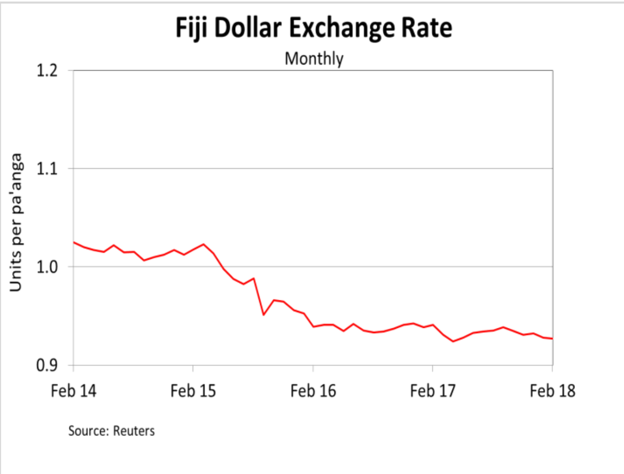
Appendix 1: Tongan Pa'anga Exchange Rates

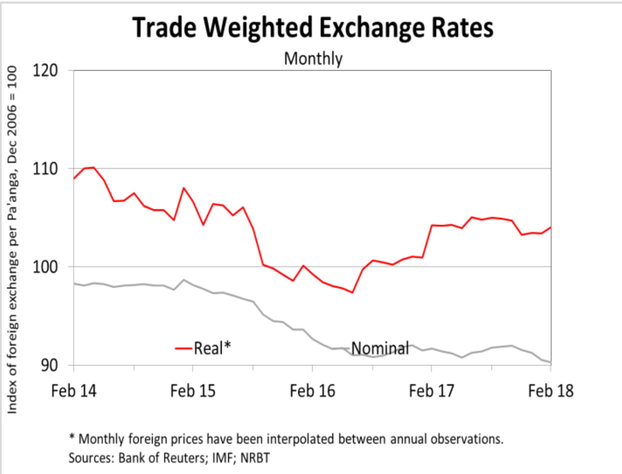












Appendix 2: Monetary Policy Objectives

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

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

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

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

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

An adequate level of foreign reserves also minimizes volatility in the exchange rate and provides confidence that businesses and individuals in Tonga are able to meet their foreign currency obligations. The Reserve Bank targets a level of foreign reserves equivalent to 3 to 4 months of imports.

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

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

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

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