National Reserve Bank of Tonga

Monetary Policy Statement

August 2018

NATIONAL RESERVE BANK OF TONGA

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Contents

List of abbreviations

AUD	Australian Dollar
EXIM	Export-Import
FEDs	Foreign Exchange Dealers
GDP	Gross Domestic Product
IMF	International Monetary Fund
MAFF	Ministry of Agriculture, Food & Forests
MPS	Monetary Policy Statement
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

In the past six months to August 2018, the Reserve Bank maintained its current accommodative monetary policy stance. This supported meeting the monetary policy objectives by ensuring an adequate level of foreign reserves was maintained above 3 months of import cover and the exchange rate remained competitive. Inflationary pressure remains as the inflation rate was slightly above the reference rate of 5% per annum in August, however, it is expected to fall below the reference rate in the near term. Despite the strong credit growth over the year, financial stability was maintained with no signs of overheating and there is still excess liquidity in the banking system.

The Reserve Banks' outlook for a stronger real Gross Domestic Product (GDP) growth of 3.1% in 2017/18 remains. The favorable growth is anticipated to be led by the trade, agricultural, utility, fisheries, transport & communication and ownership of dwellings sectors. Growth is expected to remain strong in 2017/18, supported mainly by the implementation of infrastructure projects and ongoing housing construction projects, upgraded power supply, and improved performance in the above-mentioned sectors despite the impact of Tropical Cyclone (TC) Gita. The agricultural production further increased over the year which was attributed mainly to the favourable weather conditions resulting in better yields for squash, taro, yam, and watermelon before TC Gita struck Tonga. According to the Domestic Market Survey Report for 2017/18, the total agricultural produce available for sale at the domestic market increased by 1,247.1 tonnes (40.5%) when compared to 2016/17. The total agricultural export volume also rose over the year to June 2018 by 1,362.9 tonnes (11.8%) compared to a growth of 33.0% in the year ended June 2017. Growth was driven mainly by higher exported volumes of squash which rose by 1,575.6 tonnes (38.3%), followed by the exports of taro and yam which increased by 803.7 tonnes (172.1%) and 208.4 tonnes (12.2%) respectively.

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

Over the past six months to August 2018, the overall Overseas Exchange Transactions (OET) balance recorded a surplus of $27.0 million. This corresponds to an increase in the foreign reserves from $448.0 million in February 2018 to $475.0 million in August 2018. The financial account recorded the highest surplus, followed by the surpluses in the capital account and the current account.

The official foreign reserves was sufficient to cover 7.7 months of import of merchandise goods and services[1], which remained above the Reserve Bank's minimum of 3 months of import. In the year ended terms, gross official foreign reserves rose by $70.0 million. This was due mainly to higher remittance receipts, and higher receipts of foreign aid from donor partners and budgetary support for the Government.

Over the 6 months to August 2018, the banking system continued to remain sound. A strong capital position was maintained, supported by banks' comfortable profitability, high liquidity, and low non-performing loans. The total banks' lending reached a new high record in August 2018. Similarly, the deposits continued to rise to new heights which are in line with the increase in the foreign reserves. The weighted average interest rate spread widened over the 6 months to August 2018.

Liquidity in the banking system (reserve money) also hit a new high record of $334.2 million, attributed mainly to higher deposits by the commercial banks to the Reserve Banks vault supported by higher

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

Statutory Required Deposits (SRD). Broad money rose to its second peak point of $606.0 million, supported by an increase in both net foreign assets and net domestic assets. The receipts of TC Gita relief funds, budgetary support and project funds contributed to higher foreign reserves and the rise in net foreign assets whereas a decline in Government deposits drove the rise in net domestic assets. The banks' total loans to deposit ratio remained 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 the banks.

The net credit to Government from the banking system data rose over the past six months, due to a decrease in Government deposits. The payout of the Government's TC Gita recovery assistance, the implementation of donor funded projects and the delay in budget support receipts that was budgeted to be received before June 2018 may have contributed to this lower deposits.

Outlook

The anticipated stronger growth of 4.5% for 2018/19 remains due to the projected growth from various sectors such as the agricultural, construction, trade, utilities, mining & quarrying, transport & communication and ownership of dwellings sector. The latest climate update by the Tonga Meteorological Service[2] indicated that there is approximately a 70% chance of El Niño occurring in 2018. Rainfall forecast is expected to fall below average for the remainder of 2018 and to continue into the first quarter of 2019. This may have a negative impact on the primary sector and other sectors of the economy.

The Reserve Bank anticipates inflationary pressures 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 at the beginning of 2019. The developments 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 of 3 months of import cover supported by expected higher receipts of budgetary support and grant funds from development partners and expected higher receipts of remittances. This will be partially offset by the projected rise in imports.

The Reserve Bank projects a credit growth of 13% for 2018/19. Seasonal festivals and cultural obligations coupled with the ongoing business endeavours will continue to support credit growth. The excess liquidity in the banking system remains indicating available capacity for further lending by banks. 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. Non-performing loans are also likely to decline in the near future.

Net credit to the Government is also anticipated to decrease as a result of expected Government budgetary support and Government grants receipts, as well as improved Government revenue collection. The Reserve Bank will closely monitor the implication of the fiscal policy measures on the monetary policy objectives.

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

[2] Issued by the Ministry of Meteorology, Energy, Information, Disaster Management, Environment, and Climate Change & Communication on 11th October 2018.

Sione Ngongo Kioa
Governor

1. Global Developments

World Growth

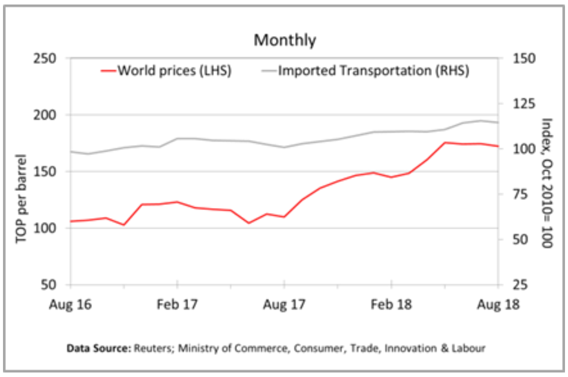
The IMF in its October 2018 World Economic Outlook (WEO) stated that global economic growth remained steady. However, in the past six months, the downside risks to global growth have increased stemming from elevated political and trade uncertainties. Therefore, compared to the forecasts in the IMF April 2018 WEO, global growth is now projected at 3.7% for 2018 and 2019 which is 0.2 percentage points lower for both years. Further supporting these projections are higher oil prices and expected weaker economic growth in most advanced economies such as the US.

Furthermore, in advanced economies, economic activity slowed in the first half of 2018 as outcomes fell short of projections for countries such as the United Kingdom as well as the Euro Area. Core inflation varied across advanced economies with Japan and the Euro Area below their target objectives whilst the US and the UK were close to their target objectives. However, commodity prices increased according to the IMF's Primary Commodities Price Index which recorded a 3.3% rise over the 6 months to August 2018. This was driven by higher energy prices (including oil prices).

World Oil Prices

According to Reuters, world oil prices averaged around US$73.76 per barrel in August 2018. This is an increase compared to February 2018 where prices averaged around US$66.54 per barrel. This is also higher than an average of US$51.87 per barrel a year ago. Oil prices are at its highest since 2015 resulting from cuts in supply production.

Figure 1: World Oil prices



However, the IMF October 2018 WEO suggests that oil prices are expected to average at US$69.38 per barrel in 2018 (higher than the April 2018 WEO projection of US$62.3 per barrel for 2018). Global oil supply is expected to gradually increase over the forecast horizon, lowering oil prices to US$68.76 per barrel in 2019 and further to about US$60 per barrel in 2023.

Additionally, oil prices rose to more than $76 per barrel in June 2018 and this is the highest level since November 2014. This reflects the collapse in Venezuela's production, unexpected outages in Canada and Libya, and expectations of lower Iranian exports following US sanctions. However, prices dropped to about US$71 per barrel in August following a decision by the Organization of the Petroleum Exporting Countries (OPEC) and the non-OPEC exporters (including Russia) to increase oil production. This agreement which was held in June 2018 was made to offset the declining output in Venezuela and Angola.

Advanced Economies

The IMF October 2018 WEO reports that the U.S. GDP is expected to record a growth rate of 2.9% in 2018. This is supported by the pro-cyclical fiscal stimulus after eight consecutive years of expansion and loose financial conditions. For 2019, the US is expected to grow by 2.5% (revised downwards by 0.2% since the IMF April 2018 WEO). This stems from the recently introduced trade measures. Nevertheless, strong domestic demand is projected to push the economy above full employment and increase imports. Unemployment rates in the US were also reported to be at its lowest level since 2000. Moreover, the monetary policy stance should be gradually tightened as inflation pressures rise amid solid growth and historically low unemployment. As such, the Federal Reserve raised the target range of the federal funds rate to 1.75 – 2.0% in June. With economic expansion in the US gaining momentum, and a sizeable fiscal stimulus anticipated to amplify already buoyant private sector activity, the Federal

Reserve also signaled two additional rate hikes in 2018 and three in 2019. Headline consumer price inflation is projected to increase to 2.4% in 2018 and 2.1% in 2019 from 2.1% in 2017. These projections are driven by higher energy prices and housing expenses.

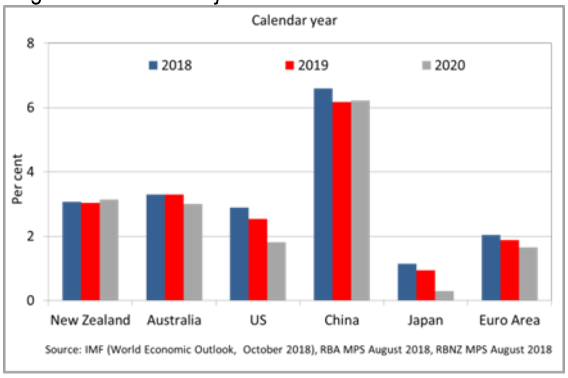
The Reserve Bank of Australia (RBA) stated in its August 2018 MPS that the Australian economy remains on track to achieving lower unemployment and higher inflation over time. Furthermore, GDP is expected to record 3.3% growth in both 2018 and 2019. This is supported by accommodative domestic monetary policy and a positive international outlook. Furthermore, export volumes increased strongly over the first half of 2018 as new production capacity continued to come online and previous supply disruptions were resolved. A number of factors have contributed to keeping inflation low. Slow growth in labour costs has managed to contain domestic price pressures across a range of items and ongoing strong competition in the retail sector has also contributed to weakness in retail prices. More specifically, headline inflation rose by 2.1% (over the year to June 2018). Inflation rate is forecasted to record 1.8% and 2.3% respectively by the end of 2018 and 2019. This is due to uncertainty about wages growth as well as the rising oil prices. Taking into consideration the most recent developments and expectations, the RBA Board kept its cash rate unchanged at 1.5%.

The Reserve Bank of New Zealand (RBNZ) reported in its August 2018 MPS that recent economic growth moderated recording a 2.7% increase over the year to March 2018. However, this is lower than the 3.8% growth recorded for the same period of last year. The growth slowdown resulted from lower business, construction, and residential investment activities. However, economic growth is expected to pick up in 2019 fueled by fiscal and monetary stimulus. Furthermore, net exports are expected to contribute to this growth. Overall, GDP is forecasted to record 2.6% growth for 2019 and further pick up to 3.4% in 2020. This is higher than previous projections reported in the last MPS. The annual headline inflation rose by 1.5% at the end of June 2018 driven by higher wages and inflationary pressures from major trading partners. Additionally, inflation is expected to rise further by 1.8% in 2019 and 1.9% in 2020 stemming from the announced increase in the national fuel excise tax. This is expected to lift fuel prices and the headline inflation. However, inflation will still remain within the RBNZ's target range of 1-3%. Ultimately, the RBNZ left its official cash rate unchanged at 1.75% and is expected to remain at this level over the next two years.

The United Kingdom (UK) experienced weaker-than-expected outturns in the first half of the year which led to downward revisions to growth. As such, growth is projected to slow to 1.4% in 2018 and 1.5% in 2019 (from 1.7% in 2017). The 2018 IMF forecast is a downward revision of 0.2 percentage point and the unchanged 2019 forecast was driven by weak growth in the first quarter of the year partly due to weather-related factors. As the pass-through effects of the Pound depreciation fade, headline inflation is expected to decline from a forecasted 2.5% in 2018 to 2.2% in 2019. Furthermore, the headline inflation is expected to stabilize at its medium-term level of 2.0% in early 2020. A modest tightening of monetary policy may be necessary. However, at a time of heightened uncertainty, monetary policy should remain flexible in response to changing conditions associated with the Brexit negotiations.

The IMF October 2018 WEO states that the Euro Area experienced a slowdown in economic growth in the first half of 2018 following a strong surge in the final quarter of 2017. Slower export growth contributed notably to the slowdown. Consequently, growth forecasts for 2018 and 2019 are now revised downwards respectively to 2.0% and 1.9% (from 2.4% for 2018 and 2.0% for 2019 in the IMF April 2018 WEO). Healthy consumer spending and job creation amid supportive monetary policy are expected to continue to provide strong aggregate demand, though at a moderate pace. Headline inflation is expected to be 1.7% in 2018 and 2019 up from 1.5% in 2017. This is reflective of the higher energy prices. However, positive output gaps and tightening labour markets is expected to lift inflation but the increase is projected to happen slowly over the forecast horizon. Accommodative monetary policies remain appropriate for the Euro Area whilst policy rates are projected to remain negative in the Euro Area until mid-2019.

Figure 2: Growth Projection in the Advanced Economies



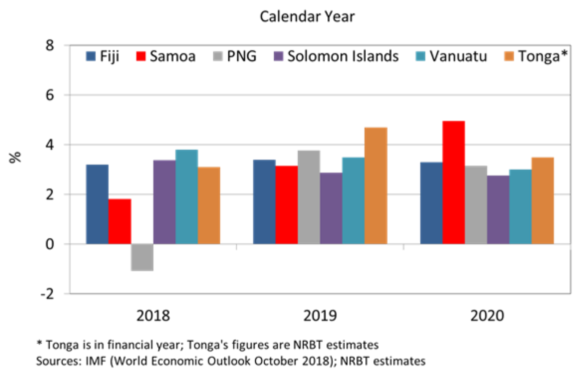
The IMF October 2018 WEO stated that growth in China will remain strong but is projected to decline gradually. This stems from China slowly bearing the impacts of weaker credit growth and rising trade barriers. However, the central bank maintained its policy rate while lowering banks' required reserve ratio to encourage lending. The 2018 GDP forecast remains unchanged at 6.6% (since the IMF April 2018 WEO) slowing down from a growth of 6.9% in 2017. As for 2019, the forecast was revised downwards to 6.2% (from 6.4% as previously projected in the IMF April 2018 WEO). The 2019 growth projection for China is lower than the IMF April 2018 WEO forecast given the latest round of US tariffs on Chinese imports. Headline inflation is expected to pick up to 2.2% this year, up from 1.6% in 2017 and to about 3.0% over the medium-term. This is driven by higher food and energy prices. In the meantime, this will continue to remain below the Government's target to hold the CPI at around 3.0%.

Japan's economy is projected to moderate to 1.1% in 2018 (from a strong above-trend outturn of 1.7% in 2017), before softening to 0.9% in 2019. The downward revision of 2018 projection (from 1.2% in the IMF April 2018 WEO) is largely due to the contraction observed in the first quarter of 2018, and given the uptick in growth and domestic demand in the second quarter of 2018, this is likely to represent a temporary dip rather than the beginning of a turn in the cycle. Japan's medium-term prospects are impeded by unfavorable demographics and a trend decline in the labour force. Headline inflation is expected to increase to 1.2% in 2018, up from 0.5% in 2017, again mainly due to rising global energy prices. However, inflation is still expected to remain below the Bank of Japan's target of 2.0% over the five-year forecast horizon, given tepid wage growth and stickiness in inflation expectations.

South Pacific Economies

The South Pacific region is expected to have an average GDP growth of about 2.3% for 2018 (down from 3.3% in the February 2018 MPS) compared with a revised 3.0% GDP growth in 2017. The slowdown in growth reflects mainly weaker than expected growth for Papua New Guinea (PNG) due to the disruption of production in LNG, crude oil, and mining following the earthquake in February this year. The Reserve Bank of Fiji stated in its September 2018 economic review, that Fiji's recent economic performance was mixed but generally positive. This was led by a thriving tourism sector and higher timber production whilst sugar production fell.

Figure 3: Growth Projections in the Pacific



The Central Bank of Samoa reported following its board meeting in August that GDP is expected to grow by 1.0% in 2017/18 down from 2.5% GDP growth in 2016/17 due largely to the full closure of the Yazaki Samoa plant as well as reductions in the output of the Fishing, Agricultural, and Financial Services sectors. However, expectations for growth across the economies are generally 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).

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

	Real GDP growth (%)			Inflation (%)			Unemployment* (%)		
	2018f	2019f	2020f	2018f	2019f	2020f	2018f	2019f	2020f
World Growth	3.7	3.7	3.7						
Australia	3.3	3.3	3.0	1.8	2.3	2.3	5.5	5.3	5.0
China	6.6	6.2	6.2	2.2	2.4	3.0	4.0	4.0	4.0
Euro Area	2.0	1.9	1.7	1.7	1.7	2.1	8.3	8.0	7.7
Japan	1.1	0.9	0.3	1.2	1.3	1.3	2.9	2.9	2.9
New Zealand	2.7	2.6	3.4	1.6	1.8	1.9	4.4	4.4	4.2
United Kingdom	1.4	1.5	1.5	2.5	2.2	2.0	4.1	4.2	4.5
United States	2.9	2.5	1.8	2.4	2.1	2.2	3.8	3.5	3.4

Note: f – forecast

Source: IMF (World Economic Outlook, October 2018), NRBT, RBA August 2018 MPS, RBNZ August 2018 MPS

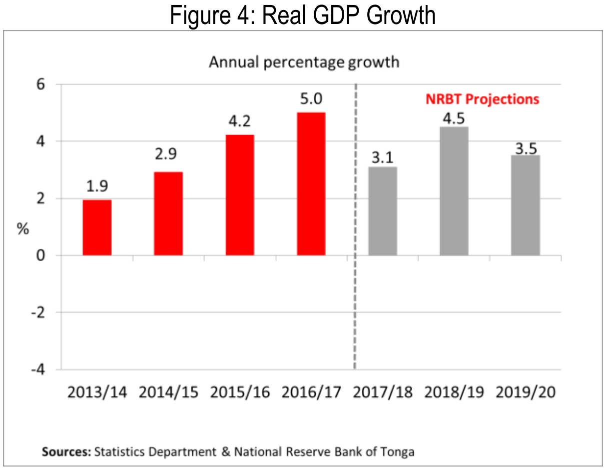
2. Tonga's Economic Growth

Real GDP Growth

The domestic economy is anticipated to have grown by 3.1% in 2017/18 recording its 5th year of consecutive growth despite the devastating effects of Tropical Cyclone Gita (TC Gita) in February 2018. Although this is slower than the 5.0% growth in 2016/17, the favorable growth is anticipated to be led by the trade, agricultural, utility, fisheries, transport & communication and ownership of dwellings sectors. It is expected that the post-TC Gita rehabilitation work will support consumption and investment in the economy, offsetting the contraction in fisheries exports and electricity production. This will contribute to the economic growth of 2018/19 and the spillover to subsequent financial years.

A stronger growth of 4.5% in 2018/19 is expected before slowing to 3.5% in 2019/20. Tonga Meteorological Service in its latest climate update indicated that there is approximately a 70% chance of El Niño occurring in 2018. Rainfall forecast is expected to fall below average for the remainder of 2018 and continue to the first quarter of 2019. This may impact the primary sector and other sectors of the economy in the future.

Figure 4: Real GDP Growth

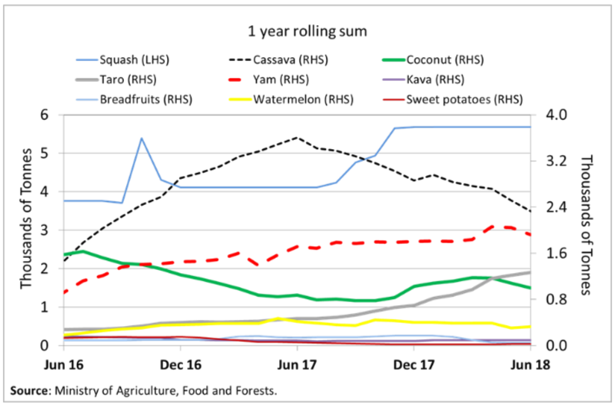


Primary Production

Following a positive 1.3% growth in 2016/17, the primary sector is expected to reflect a slower growth of 0.9% in 2017/18 due mainly to expected slowed growth in the agricultural sector which holds the largest share of production in Tonga's economic activities. A rebound in growth for the forestry and fishing sectors are expected following the negative growths recorded in 2016/17. The growth in the primary sector for 2017/18 was further revised downward from 1.2% to 0.9% due to adverse effects of TC Gita. A stronger growth of 2.0% is forecasted for 2018/19 before slowing to 1.6% in 2019/20.

Growth in the agricultural sector remained unchanged at 1.0% as reported in the February 2018 MPS. The expected growth is supported by favorable weather conditions during the first half of the financial year which resulted in an increase in both domestic production and export volume. In the year to June 2018, the total volume of agricultural exports increased by 1,362.9 tonnes (11.8%) to a total 12,955.6 tonnes. This was supported by a better season for fruit products such as squash and brown coconuts, and harvest of root crops such as taro and yam. 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 803.7 tonnes (172.1%) increase in exported taro. While the volume of taro has recovered well from the drought in 2015 which affected both harvest and seedlings; TC Gita damaged the export quality of cassava.

Figure 5: Volumes of Major Exported Agricultural Exports



In addition, reports from the domestic agricultural market conveyed that crops sold domestically rose by 1,247.1 tonnes (48.7%) in the year to June 2018. Almost all crops available in the domestic agricultural market increased except for a few fruit produce which declined over the year. However, agricultural export proceeds reported by the banking system in 2017/18

Table 2: Real GDP Growth Forecast

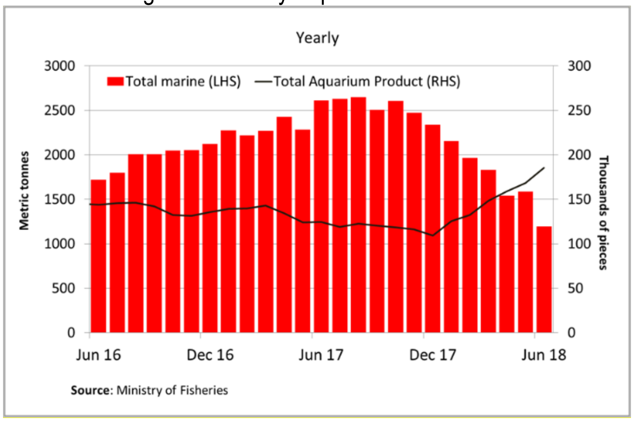
	Revised 2015/16	Preliminary 2016/17	FY 2017/18 (Feb-18 MPS) %	FY 2017/18 (Revised) %	FY 2018/19 (Feb-18 MPS) %	FY 2018/19 (Revised) %	FY 2019/20 (Feb-18 MPS) %	FY 2019/20 (Revised) %
GDP	4.2	5.0	3.1	3.1	4.5	4.5	3.7	3.5
Primary production	0.5	**1.3**	**1.2**	**0.9**	**2.2**	**1.9**	**2.0**	**1.6**
Agriculture	-0.4	1.6	1.0	1.0	2.0	2.0	2.0	1.5
Forestry	-20.2	-0.6	2.0	2.0	2.0	1.0	0.5	0.5
Fishing	8.9	-0.1	2.0	0.1	3.5	2.0	2.0	2.0
Secondary production	9.7	**11.1**	**7.5**	**7.2**	**10.0**	**10.0**	**7.2**	**7.2**
Mining and quarrying	-20.3	16.5	5.0	5.0	7.0	6.0	5.0	5.0
Manufacturing	1.3	3.8	6.0	6.0	3.0	3.0	3.0	3.0
Utilities	9.2	8.9	2.0	0.1	7.0	7.0	5.0	5.0
Construction	19.2	16.4	10.0	10.0	15.0	15.0	10.0	10.0
Tertiary production	**4.7**	**3.4**	**2.0**	**2.2**	**3.1**	**3.1**	**2.8**	**2.8**
Trade	11.0	7.7	2.0	2.5	4.0	4.0	4.0	4.0
Hotels, restaurants	7.2	3.7	1.5	1.5	2.0	2.0	2.0	2.0
Transport, communication	0.0	8.7	2.0	2.0	4.1	4.1	4.0	4.0
Financial intermediation	12.6	1.5	7.5	7.5	7.0	7.0	5.0	5.0
Real estate, business services	6.7	7.3	1.0	2.0	2.0	2.0	2.0	2.0
Public administration	0.4	-1.7	1.0	1.0	1.0	1.0	1.0	1.0
Education	-3.1	8.2	1.0	1.0	2.0	2.0	2.0	2.0
Health and social work	8.6	0.0	2.0	2.0	1.5	1.5	1.5	1.5
Recreational, cultural activities	5.1	0.0	1.0	1.0	2.0	2.0	2.0	2.0
Other community services	19.5	2.2	2.0	2.0	1.5	1.5	1.5	1.5
Ownership of dwellings	0.1	0.6	0.5	0.5	3.0	3.0	2.0	2.0
Other*	6.7	7.9	1.0	1.0	1.0	1.0	1.0	1.0

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

declined by $0.1 million (0.9%) to $10.8 million. The lower export receipts may be due to proceeds left abroad as well as the time lag effect for these proceeds to be received in Tonga. The increase in non-commercial agricultural exports where individuals send crops to families abroad may have also contributed to the decline in the receipts of export proceeds.

The outlook for the agricultural sector remains firm as a result of initiatives to assist the grower's recovery from TC Gita. This includes providing free of charge land and field plough per district and distributing seedlings to the growers in Tongatapu and 'Eua. Hence, a 2.0% growth is expected for 2018/19 before slowing to 1.5% in 2019/20. This is supported by the various initiatives from the Government to help growers, and the positive sentiment reflected by growers through the Reserve Bank's liaison program towards recovery and replanting of crops following the cyclone. However, the greatest risk to the outlook of this sector is the uncertainty in the weather conditions and the sustainability of land that has been farmed continuously.

Figure 6: Fishery Exports



Growth in the fisheries sector for 2017/18 was further revised downward from 2.0% to 0.1% due to damages caused by TC Gita to fishing vessels which affected fishing activities. In the year ended to June 2018, the volume of marine exports (excluding aquarium products) declined by 1,414.2 metric tons (54.2%). The volume of all exported marine products declined due to the lower number of registered fishing boats in 2017/18. However, aquarium exports increased by 60,974 pieces (49.0%) mainly driven by a rise in exported invertebrate. Consequently, total fisheries and other marine products export proceeds declined by $3.2 million (26.1%) coinciding with the decline in the exported volume of fish.

The on-going initiatives from the Ministry of Fisheries may increase and sustain the supply of fisheries product and contribute to increasing the total exports. Such initiatives include the Seafood Export Market Development including Market Development for Pearl which explores new markets to increase opportunities for fisheries exporters and pearl farmers in both Vava'u and Ha'apai. The Aquaculture Management and Development plan includes preparations for developing and improving seaweed planting and marketing. Additionally, the National Strategy on Aquatic Biosecurity which deals with biological risks in aquatic environments will help sustain this industry. The fisheries sector continues to benefit from the duty exemptions policy on fuel and fishing gear and the initiatives of the Government's Fisheries Development and Export Fund through the Government Development Loans facilitated by the Tonga Development Bank. Growth is expected to continue into 2019/20 at 2.0%. However, adverse weather and maintenance of the fishing boats remain the largest risk to the potential growth of the sector.

Projected growth for the forestry sector is unchanged at 2.0% for 2017/18, before reverting to a slower growth of 1.0% in 2018/19 and 0.5% in 2019/20. The rebound in 2017/18 following a negative 0.6% growth in 2016/17 is due to the network upgrade projects in Tongatapu and Vava'u by Tonga Power Limited for 2017/18 and will continue to 2018/19, requiring more than 9,000 electric poles which may increase the demand for poles supplied by Aotearoa-Tonga Forest Product Limited, hence contribute to the sector growth. However, the competition from overseas firms may pose a risk to this expected contribution to the sector growth.

In addition, plentiful supply of firewood after TC Gita is another proxy indicator for this sector.

Secondary Production

Growth for 2017/18 was further revised downward to 7.2% from 7.5% as a result of disruptions caused by TC Gita on the utility sector. Sluggish growth is expected of the utility sector in 2017/18 because of severe damages to the electricity services which also slowed services in water supply due to its reliance on electrical energy. Growth projections for the industrial sector in the medium term remained at 10.2% for 2018/19 and 7.2% for 2019/20.

The largest share of production in the secondary sector, the construction industry, is expected to grow at 10.0% in 2017/18 supported by an increase in individual housing and business construction loans. Lending to businesses for construction purposes increased by $1.9 million (18.9%) whilst lending to individual housing rose by $20.2 million (11.8%) in 2017/18. Reconstruction after TC Gita and payouts by insurance companies to some affected businesses and households would contribute to growth in 2017/18 and subsequent fiscal years. Public constructions completed during the year included the Taufa'ahau Tupou IV Wharf building, Tailulu College Hall and Talamahu market reconstruction/new marketplace.

The demand for housing renovations and new constructions are expected to increase, supported by the tax exemption period for construction materials following TC Gita. Although, lending to households has slowed due to their capacity to borrow and also capacity constraints for construction companies due to the high demand has delayed the progress of reconstruction. Hence, a strong outlook for the construction sector of 15.0% is projected for 2018/19 and 10.0% in 2019/20 as a result of reconstructions and delayed projects from 2017/18. These include new offices and construction such as the Tonga College's Hall, new office building for the Utility sector, Customs Office building and various other private construction work such as expansion of few businesses including Pacific Timber & Hardware store and Cost Low to name a few, are expected to drive growth in the upcoming years. The developments in the construction sector are expected to have spillover effects on other sectors of the economy such as mining and quarrying activities, manufacturing, utilities, transportation, and trade.

Developments in the mining & quarrying sector are expected to be in line with the projected vibrant construction sector. Growth for 2017/18 is expected to be around 5.0% and to be followed by a further 6.0% growth in 2018/19.

Following the aftermath of TC Gita, demand for manufactured goods such as water bottles, plastic water tanks, paint, cement & concrete, and hardware manufacturing increased. This positive impact on manufacturing businesses will contribute to the expected 6.0% growth in the manufacturing sector in 2017/18. Increased investments in manufacturing of consumer goods contributed to higher sector growth. Higher migration movements and increased travel receipts supported the demand for handicrafts and were mainly reflected in the higher exported handicrafts of 22.7 tonnes (22.4%). Kava-Tonga production has also recovered and is on the rise to meet high demand from both domestic and foreign buyers. This is reflected in the 11.2 tonnes (13.2%) increase in exported kava-Tonga powder which further contributed to the positive performance of the sector.

Assessment of TC Gita impacts resulted in the downward revision to the utility sector. This was reflected in lower electricity consumption by 1.4 million kW in 2017/18 coinciding with a 0.9 million kW fall in electricity production. However, given the expected developments in the construction sector coupled with the scheduled network upgrade projects, the utility sector is forecasted to reflect a robust growth of 7.0% in 2018/19. The movements in the global oil price are also expected to impact growth in the utilities sector.

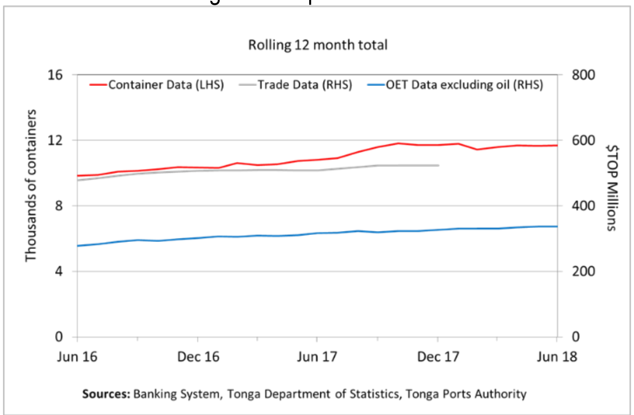
Tertiary Production

A slower growth is expected for almost all other sectors in the tertiary sector in 2017/18 except for financial intermediation and public administration. This is due to the impact of TC Gita which has weakened economic activities in these sectors. The slight upward revision of growth in the trade sector and real estate & business services compared to the figures reported in the February 2018 MPS has driven the forecasted growth for the services sector higher to 2.2% from 2.0%. A more robust growth of 3.1% is expected for 2018/19 before reverting to a slower growth of 2.7% in 2019/20. There have been no revisions to the forecasts for the sub-sectors as published in the February 2018 MPS.

Despite the damages caused by TC Gita to the transportation sector which may have slowed down trade activities, in-kind cyclone relief donations from donor charity organizations and Tongan families living abroad increased imports. Tax exemptions on imported immediate goods by individuals after the cyclone contributed to growth in trading activities. The trade sector is expected to have shown real growth of 2.5% in 2017/18. This was supported by increased household disposable income levels as remittances rose over the year to June 2018 by $38.3 million (12.4%). Container registrations increased by 857 registrations (7.9%) as both business and private containers rose by 8.5% and 7.2% respectively which indicated a higher level of imported goods. Import payments for wholesale & retail goods also rose by $50.4 million (25.4%) and were supported by the opening of Cost Low during the first half of 2017/18. Events held during the year and the rise in private constructions supported this growth.

A stronger growth of 4.0% is expected for trade sector in the current and next financial year. This coincides with the projected strong growth in remittances and the optimistic outlook for a continuous increase in new loan commitments to households will support the growing level of demand for goods and services. Tax exemptions on daily consumer goods such as chicken and various vegetable products would also contribute to the anticipated strong trade growth. Infrastructure activities for reconstruction, new buildings and roads will also drive imports in the near future.

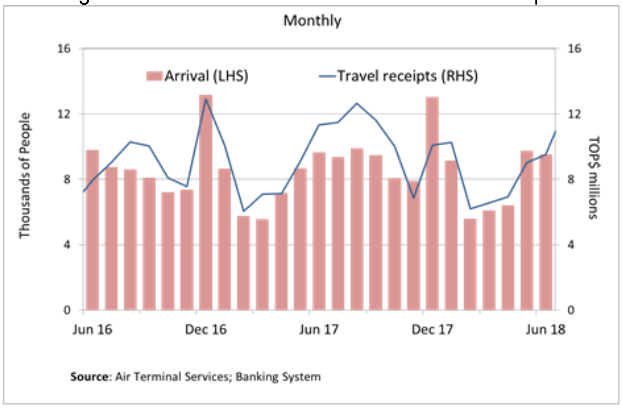
Figure 7: Import Indicators



Slower growth of 1.5% is expected for the tourism sector in 2017/18 compared to a 3.7% growth in 2016/17. Although the negative effects of TC Gita may have slowed activities in the tourism sector, some partial indicators were positive. Available data in the year to June 2018 shows that international air arrivals rose by 5.7% supported by an increase in the total number of flights arrival by 136 (13.3%). This also coincided with a $2.5 million (2.3%) increase in travel receipts. Annual events held during the year such as church conferences and school anniversaries also contributed to this growth. On the outlook, the tourism sector is anticipated to reflect stronger growth in the upcoming financial year.

Continued strong growth of 7.5% is expected in the financial services in 2017/18 and is attributed to strong credit growth. This was supported by an accommodative monetary policy stance to encourage banks to lend its funds to the public and affordable lending rates offered by financial institutions. Over the year to June 2018, total banks' lending increased as more loans were extended to both businesses and individuals. Business lending rose over the year due mainly to growth in loans extended to public enterprises, wholesale & retail, transport, and tourism sectors. This indicates the private sector's high demand for loans to support investments and various economic activities throughout the year. Higher household lending was driven by housing loans which reflected individuals' ability and capacity to access loans and funding for reconstruction following TC Gita. Lending by non-bank financial institutions rose over the year to June by 15.3% due to higher home improvement loans, small personal loans, and household loans.

Figure 8: International Air Arrivals & Travel Receipts



Henceforth, financial intermediation sector is expected to continue to grow at a slower pace in the medium term. Improved economic conditions, increased access points, recent business performances, and positive business and consumer confidence are expected throughout the current financial year which will further support the Reserve Bank's growth forecast in financial intermediation. The Reserve Bank's monetary policy to encourage the utilization of the excess liquidity in the banking system to support economic activity supports this outlook.

Real growth in the real estate and business services sector was revised up to 2.0% from 1.0%. This upward revision stems from Government's priority to support the private sector to contribute to the economy's growth. Liaison with businesses in various sectors indicated plans for improvement to business operations and processes.

The number of houses destroyed by TC Gita diminished the housing stocks, however, it is estimated to have been partially outweighed by new buildings that were completed during the financial year. On the outlook for ownership of dwellings, the reconstruction after TC Gita coupled with expected new constructions will result in stronger growth in 2018/19.

Unemployment

The unemployment rate remains unchanged[3] as reported in the February 2018 MPS. According to the Reserve Bank's survey of job advertisements in 2017/18, recruitment intentions rose by 80 job advertisements driven by higher recruitment intentions from the services sector. Increase in job advertisements over the year was noted for public administration, community services, trade and financial intermediation sectors. 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.

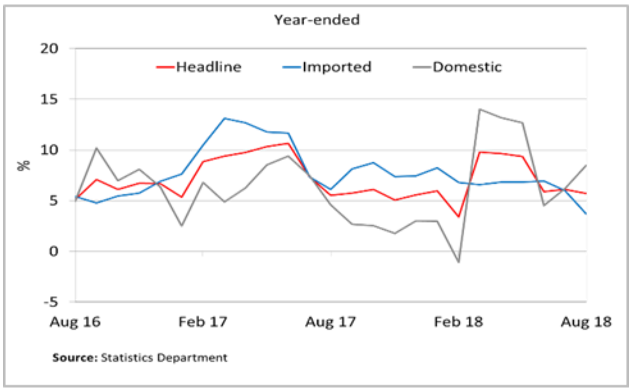
[3] Unemployment rate of 1.1% refer to not working, available & looking for work, 16.4% refer to not working, available & willing to work and 34.8% refer to including subsistence workers

3. Promoting Low and Stable Inflation

Recent Developments

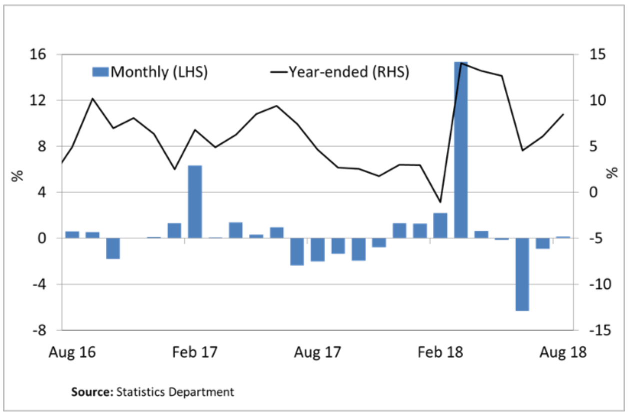
The annual headline inflation remained above the Reserve Bank's reference rate over the past six months. A hike of 9.8% was recorded in March 2018 compared to 3.4% in February 2018. The high headline inflation was mainly driven by local prices due to the TC Gita effect on the local food supply. In August 2018, the annual headline inflation slowed to 5.7% compared with 6.1% recorded in July 2018 although it is slightly higher than 5.5% in August 2017 (Figure 9).

Figure 9: Inflation



Domestic inflation rose to 8.4% over the year to August 2018 making up 3.6 percentage points of the headline inflation. The price of local food has become the major driver of domestic inflation followed by kava-Tonga and other housing commodity prices. Although the recovery from TC Gita has slowly improved the domestic food supply in the past few months, the price comparison to a year ago increased.

Figure 10: Domestic Inflation



Total domestic food prices rose by 13.4% led by a 25.4% increase in the prices of fruits & vegetables, an 11.5% rise in meat, fish & poultry and price rises reflected in various other food categories (Table 3). The second highest contributor was the price of kava-Tonga which rose over the year by 41.5% to an average price of $150/kg. Kava-Tonga prices increased significantly over the year due to short supply which started in 2015, since then its high price has been maintained.

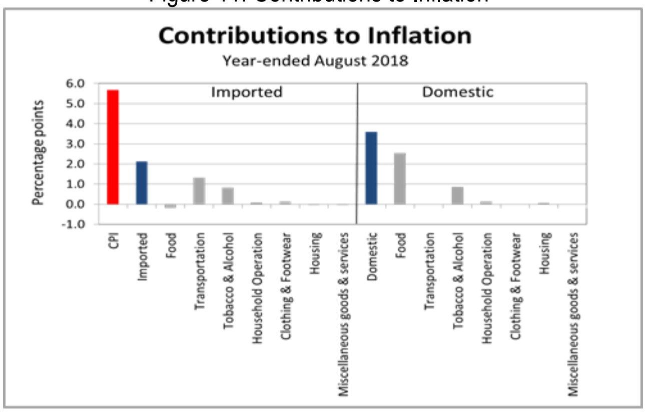
Table 3: Food items contributing to domestic inflation

	($ per kg)		Annual	
Items	Aug-18	Aug-17	$ change	% Growth
Lu	9.75	6.53	3.22	49.3
Tuna	16.00	13.00	3.00	23.1
Stringed fish (mixed)	10.91	9.58	1.33	13.9
Watermelon	3.27	1.96	1.31	66.8
Yams - early	6.35	5.20	1.15	22.1
Cockles (to'o)	6.39	5.42	0.97	17.9
H/Cabbage	2.09	1.14	0.95	83.3
Octopus	15.95	15.05	0.90	6.0
Eggs	17.38	16.63	0.75	4.5
Coconut (green)	1.82	1.16	0.66	56.9
Coconut (dry)	1.47	0.81	0.66	81.5
Manioke	1.09	0.53	0.56	105.7
Yams - late	2.88	2.56	0.32	12.5
Tomatoes	3.81	3.75	0.06	1.6
Talo - Futuna	1.95	1.94	0.01	0.5
Kumala	2.62	2.88	-0.26	-9.0
Sausages	6.65	7.00	-0.35	-5.0
Capsicum	7.94	8.32	-0.38	-4.6
Talo - Tonga	2.25	3.06	-0.81	-26.5

Source: Statistic Department

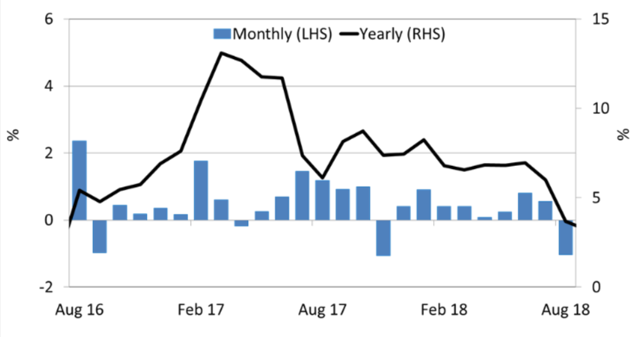
Prices of other local goods which also increased included house maintenance goods and household furniture, furnishing & textiles and supplies, and services. These outweighed the annual decline in communication services and electricity prices.

Figure 11: Contributions to Inflation



Nonetheless, the annual imported inflation recorded its lowest since the prices started rising in July 2016 when new excise tax and customs duties were introduced on a variety of imported goods. The annual imported inflation was 3.7% in August 2018 and accounted for 2.1 percentage points of the overall headline inflation. This was mainly driven by higher fuel and tobacco prices. World oil prices rose over the year by 53.0% which has a flow-on effect to the domestic fuel price with a lag of 1–2 months. The Brent crude oil was US$77.77 per barrel in August 2018 compared to US$50.82 per barrel in August 2017. This was reflected in the increased price of diesel and petrol over the year of 21.9% and 18.3% respectively.

Figure 12: Imported Inflation



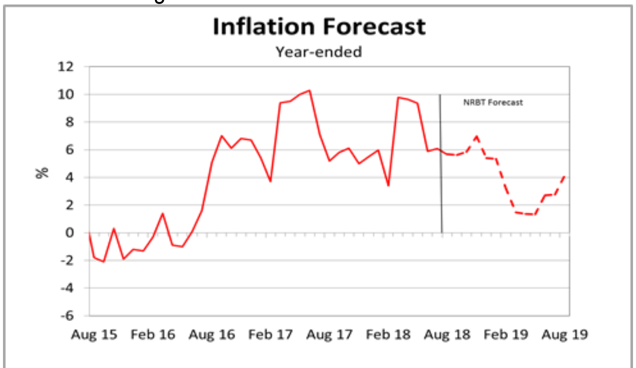
Source: Statistics Department

In addition, the price of tobacco rose by 20.5% due to a 21.2% rise in the price of Winfield blue tobacco. Further upward revisions to the excise tax of tobacco that was effective in July 2018 contributed to higher prices. Higher prices for imported goods over the year was also noted in the clothing and footwear supplies and household operation goods such as household appliances, furniture, and various other supplies. These price increases outweighed a 0.7% annual deflation of imported food due to the high prices in August 2017 and the removal of the excise tax on chicken pieces.

Outlook

The Reserve Bank anticipates 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 at the beginning of 2019. The movements in global food and oil prices may pose a risk to this outlook. Additionally, Tonga's vulnerability 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 high inflation which include assessing the effects of the exchange rates, new tax introduced, and also the businesses' profit margins.

Figure 13: Headline Inflation Forecast

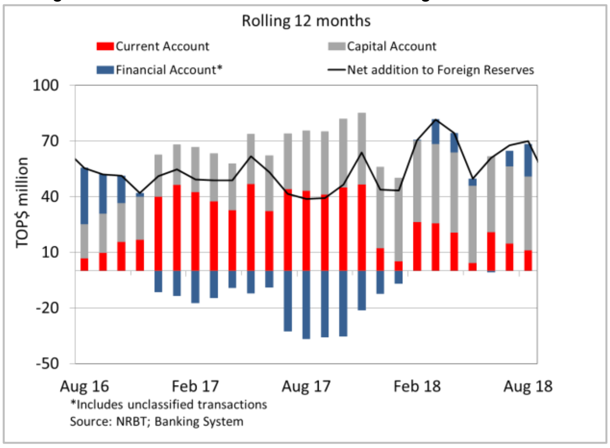


Source: Statistics Department, National Reserve Bank of Tonga

4. Maintaining Adequate Level of Foreign Reserves

Given one of the Reserve Bank's main functions is to maintain an adequate level of foreign reserves above 3-4 months of import cover, it continued to carefully monitor the country's external monetary position. On that note, from the 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 14: Balance of Overseas Exchange Transactions



Balance of Overseas Exchange Transactions

Over the past six months to August 2018, the overall OET balance recorded a surplus of $27.0 million, which was lower than a surplus of $43.0 million for the last six months to February 2018. The overall surplus corresponds to an increase in the foreign reserves from $448.0 million in February 2018 to $475.0 million in August 2018. Financial account recorded the highest surplus, followed by the surpluses in the capital account and the current account.

The overall OET balance over the year also recorded a surplus of $70.0 million, which was 80.5% higher than the surplus of $38.8 million recorded in the year ended August 2017. The rising surplus in the capital account over the year was the major driver of the higher annual overall surplus.

Current Account

The balance of the current account over the six months to August 2018 narrowed to $1.1 million, compared to a surplus of $10.0[4] million in the last six months to February 2018. This was largely attributed to the widening in the trade deficit in the past six months to August 2018.

Annually, the current account balance recorded a surplus of $11.1 million compared to a surplus of $43.1 million in the year ended August 2017. The current account payments mostly imports and primary income payments increased at a faster rate than the rise in the current account receipts for private remittances and gifts.

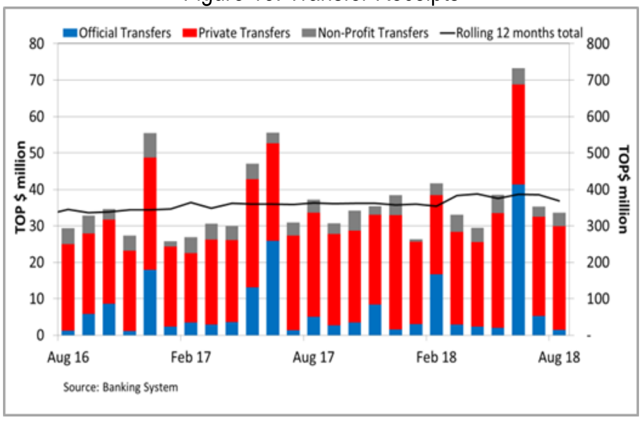
Current Account Receipts

- Transfer

Transfer receipts played a major role in the performance of the current account which accounted for 67.1%. Over the six months to August 2018, the transfer receipts increased by $36.5 million due to increases in all categories. The $19.4 million increase in the official transfer receipts stemmed from receipts of budgetary support and project funds from development partners during the period. Private transfer receipts increased by $12.7 million (8.4%) due to the increase in receipts for family support after TC Gita. The non-profit transfer receipts rose by $4.4 million, mainly due to higher inflows of grants received by non-profit organizations mostly churches and schools for technical assistance and other current expenditure. The strengthening of the USD against the TOP over the six month period ended August 2018 also benefitted Tonga as a recipient of foreign currency.

In year ended terms, the total transfer receipts rose by $15.8 million (3.6%) to $450.1 million. The receipts from private transfer rose by $18.2 million which outweighed the $2.3 million decline in receipts of non-profit transfers and official receipts decreased by $0.03 million.

Figure 15: Transfer Receipts



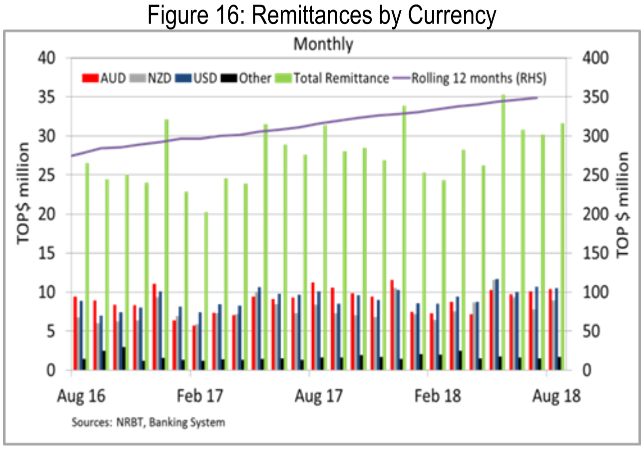
Total remittances increased over the six months to August 2018 by $15.4 million (9.2%) to $182.1 million, despite the ongoing de-risking pressures which have

[4] Data was revised since the last MPS (February 2018)

resulted in the closing of some of the authorized restricted foreign exchange dealers' bank accounts. Remittances account for 40.5% of the total OET receipts in the past six months to August 2018 compared to 42.5% in the six months to February 2018. The decline in the remittances share of the total OET receipts was attributed to higher total OET receipts which outweighed the rise in remittances. FEDs continued to be the preferred channel for receiving of remittances. Receipts of private transfers continued to be the main purpose of remittances which accounted for 90.0% of the total remittance receipts. This was mainly gifts and family support funds from relatives abroad. The total compensation of employees receipts (from seasonal workers in Australia and New Zealand and other wages and salaries) was $13.1 million and accounted for 7.2% of the total remittance received over the past six months. Private capital transfer receipts by individuals followed with a total of $4.7 million and accounted for 2.6% whilst social benefits totaled to $1.0 million and represented 0.6% of total remittance receipts.

Total remittances continued to increase over the year by 10.3% to $348.8 million and represented 42% of the total OET receipts. This was largely driven by the continued transfer of funds from families and friends abroad to support their families, as well as fund major celebrations throughout the year such as family reunions, school anniversaries celebration, churches' annual conferences and also to support families who were affected by TC Gita. It is estimated that remittances as a share of GDP for 2017/18 was 39.0%.

Figure 16: Remittances by Currency



➢ Export

Total export proceeds for the past six months to August 2018 declined by $1.8 million (17.0%) to $8.8 million. This resulted from lower proceeds from the export of agricultural products, which declined by $1.7 million due to a slowdown in agricultural exports following the completion of the squash harvest season in the previous six months. Marine export receipts also fell by $0.2 million due to lower export of fish. On the other hand, proceeds for other exports increased reflecting the higher export of jewelry within the past six months. Over the year, the total export proceeds fell by $5.5 million (21.9%) to $19.4 million. This was attributed mainly to a decline in the proceeds for all exports categories with marine export receipts declining the most by $2.6 million.

➢ Services

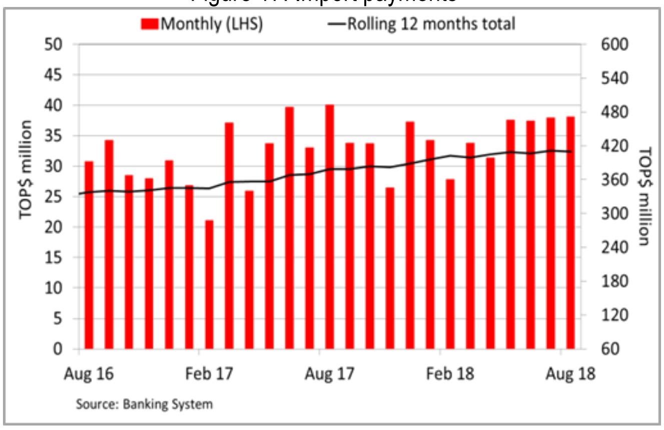
In the six months to August 2018, service receipts declined by $1.2 million. A $3.0 million decrease in transport service receipts and insurance claims fell by $1.4 million largely drove this decline. More specifically, the lower transport service receipts were driven by a fall in receipts for other modes of transport and air transport particularly airline freight services. Furthermore, lower insurance claims led to a drop in insurance receipts following the receipts of claims for TC Gita. On the other hand, travel service receipts increased as a result of higher business travel receipts in the last six months. Over the year to August 2018, total service receipts, however, rose by $13.0 million (7.1%) to $194.2 million which resulted from higher transport, insurance, and other services receipts.

Current Account Payments

➢ Imports

Over the six months to August 2018, the total current account payments increased by $45.8 million to $361.7 million largely due to higher import and service payments. All categories of import payments increased with other imported goods, mostly the Government's imports (public enterprises) which include materials for projects funded by non-Government organizations contributed the most by $9.1 million.

Figure 17: Import payments



The import payments for construction goods increased by $7.6 million contributing to the overall rise in the past six months. This coincided also with an increase in housing loans of 4.5% and in construction loans of 4.4% over the six months to August 2018 compared with the previous 6 months to February 2018. Over the year, import payments continued to rise by $30.6 million (8.1%) to $409.5 million. This was due mainly to an increase of $34.2 million in payments for the import of wholesale and retail goods followed by an $11.5 million increase in oil import payments. This was partially offset by a decrease in construction and other import payments. The improved growth in the distribution sector contributed to the increase in wholesale and retail trade import payments, which coincided with the 7.2% increase in container registrations.

- Services & Transfer payments

Service and transfer payments both increased over the six months to August 2018. Service payments rose by $23.1 million due to higher air and sea freight payments as well as travel-related and other private service payments. Transfer payments increased over the six months to August 2018 by $1.1 million due to an increase in transfers to own accounts and also non-profit transfer payments. Over the year to August 2018, both service and transfer payments increased and by $29.9 million and $13.3 million respectively. Higher service payments were attributed to higher payments for sea and air freight (transport) payments coupled with higher personal travel payments and payments for other private services. The increase in transfers of individuals to their own accounts led to the rise in private transfer payments. This in addition to the rise in official current transfers (returning of unused funds to donors) and non-profit transfer payments drove the overall rise in transfer payments over the year.

- Primary Income payments

In the six months to August 2018, primary income payments fell by $1.3 million and further declined over the year by $9.8 million. This was a result of a decline in dividends being paid out to non-resident shareholders.

Capital Account

Over the six months to August 2018, the capital account receipts declined by $11.2 million to $16.3 million, driven by a decline in private capital transfer receipts. The capital account payments also declined by $3.7 million, driven by decreases in both private capital and official capital payments for investment projects or capital expenditures for construction purposes. However, the capital account still recorded a surplus of $16.1million at the end of the six months to August 2018 reflecting lower official and capital transfer payments.

In year ended terms, the capital account continued to record a surplus of $39.8 million, rising from a surplus of $32.4 million in the year ended August 2017. This was driven by surpluses in both the official and private capital accounts. Higher receipts in both accounts outweighed the higher payments. Higher foreign aid funds received by the Government for TC Gita recovery, 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.

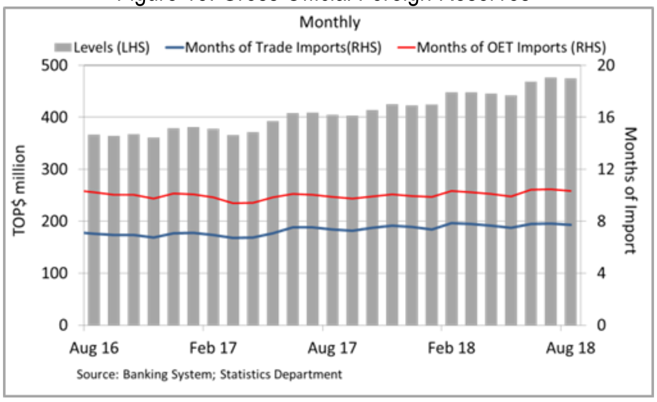
Financial Account

Over the six months to August 2018, the balance in the financial account recorded a surplus of $51.8 million, increasing significantly by $35.6 million from a surplus of $16.2 million in the past six months to February 2018. This was attributed mainly to higher receipts from other investments outweighing payments for direct investment. Over the year ended August 2018, the financial account recorded a surplus of $19.1 million compared to a deficit of $36.8 million recorded in the year ended August 2017. This reflects an increase in foreign direct investment receipts specifically, equity.

The balance of unclassified transactions recorded an average outflow of $4.1 million per month over the year to August 2018, compared to $7.6 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

Figure 18: Gross Official Foreign Reserves



The official foreign reserves remained high recording a level of $475.0 million in August 2018, compared to $448.0 million in February 2018. This was sufficient to cover 7.7 months of import of merchandise goods and services, which remained above the Reserve Bank's minimum of 3 months of import. In year ended terms, gross official foreign reserves rose by $70.0 million. The increase over the year was due mainly to higher remittance receipts, and higher receipt of foreign aid from donor partners and budgetary support for the Government.

Exchange Rates

The Nominal Effective Exchange Rate (NEER) index rose by 1.3% over the six months to August 2018 which indicates that imports were less expensive relative to the last six months due to the depreciation of AUD and NZD against the TOP. The Real Effective Exchange Rate (REER) index rose by 3.5%, reflecting the impact of Tonga's moderating inflation rate relative to its major trading partners. In year ended terms, the NEER index slightly declined by 0.3% whilst the REER index increased by 2.3% and may disadvantage the recipients of foreign currency.

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 2019 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. The rising number of people joining the RSE & SWP schemes also contributes to the 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 the 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 on 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.
- Uncertainty in the commodity prices may have negative implications on Tonga's external position as a net importer and price taker.
- Vulnerability to natural disasters also remains a risk.

5. Promoting a Stable Financial System

Over the 6 months to August 2018, the banking system continued to remain sound. A strong capital position was maintained, supported by banks' comfortable profitability, high liquidity, and low non-performing loans. The total banks' lending reached a new high record in August 2018. Similarly, deposits continued to rise to new heights which are in line with the increase in foreign reserves. The weighted average interest rate spread widened over the 6 months to August 2018.

Table 4: Consolidated Balance Sheet of Depository Corporations

	Level			YoY change	
	Aug 17 $TOPm	Feb 18 $TOPm	Aug 18 $TOPm	Aug 17 $TOPm	%
Broad money liabilities	**552.3**	**558.2**	**606.0**	**53.7**	**9.7**
Currency in circulation	60.7	65.8	69.0	8.3	13.7
Demand deposits	200.0	181.8	212.2	12.2	6.1
Savings and Term deposits*	291.6	310.5	324.8	33.2	11.4
Equals					
Net foreign assets	**429.0**	**468.1**	**494.1**	**65.1**	**15.2**
Plus					
Net domestic assets	**123.4**	**90.3**	**112.2**	**-11.2**	**-9.1**
Gross bank lending**	427.0	442.9	461.3	34.3	8.0
Other***	-303.6	-352.5	-349.1	-45.5	15.0

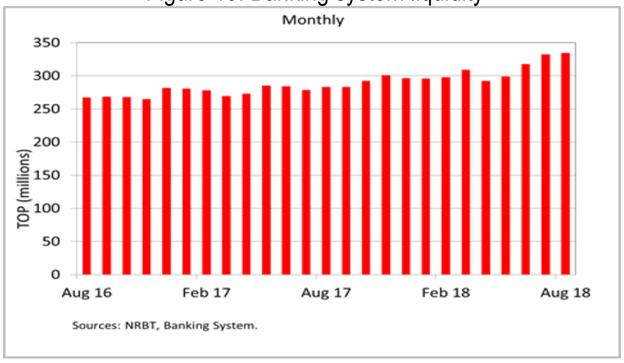
* Also includes very minor amounts for securities other than shares.
** Differs slightly from standard measures of bank lending by amounts classified as accrued interest.
*** Includes mostly capital accounts of the banks and NRBT, and their net claims on the central government.
Note: Figures may not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

Money Supply

Over the 6 months to August 2018, broad money rose to its second-highest point of $606.0 million, a $47.9 million (8.6%) rise from $558.2 million recorded in February 2018. This was attributed mainly to a rise in both net foreign assets and net domestic assets of $26.0 million and $21.9 million respectively. The receipts of TC Gita relief funds, and budgetary support and project funds contributed to the higher foreign reserves and resulted in the rise in net foreign assets whereas the decline in Government deposits drove the rise in net domestic assets. The highest record for broad money was recorded in July 2018 of $606.1 million and also for the foreign reserves which reached an all-time high of $476.5 million.

Broad money increased by $53.7 million (9.7%) over the year, due to a rise in net foreign assets outweighing the decline in net domestic assets. Again the increased Government receipts of cyclone relief funds, budgetary support and projects' funds over the year had driven the rise in net foreign assets and increased the foreign reserves. Lower net domestic assets were mainly due to higher Government 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 increase in the number of access points mainly for EFTPOS and agents/in-store banking contributed to the rise in currency in circulation. The Reserve Bank's Currency Department continued to undertake direct deposits of mint quality notes to the Reserve Bank's note trust depots in the outer islands for the interchanging and replacing of mutilated notes with good quality currency notes on a timely manner.

Figure 19: Banking system liquidity



Over the 6 months to August 2018, liquidity in the banking system (reserve money) also hit a new high record of $334.2 million, a $36.6 million increase from February 2018. This was attributed mainly to higher deposits by the commercial banks to the Reserve Bank's vault supported by higher SRD balances.

Higher deposits over the past six months further supported the growth in reserve money. In year ended terms, liquidity in the banking system continued to rise by $51.4 million (18.2%), due to higher deposits by the commercial banks to the Reserve Bank's vault.

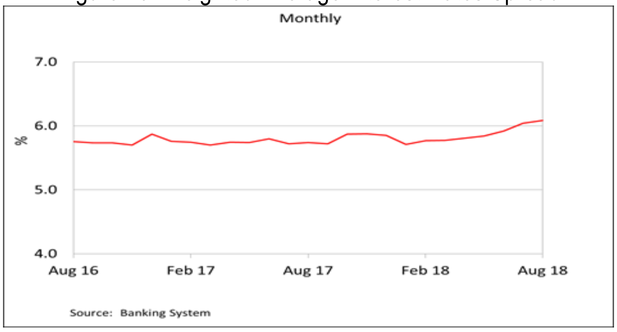
In August 2018, the banks' total loans to deposit ratio remained below the 80% minimum loan to deposit ratio at 71.5%, compared to 74.3% in February 2018 and 75.2% in August 2017. This was attributed mainly to deposits increasing at a faster pace than the growth in loans, which indicates that there is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

Interest Rates

Over the 6 months to August 2018, the weighted average lending rate increased by 22.3 basis points (from 7.85% to 8.08%) while the weighted average deposit rate fell by 9.3 basis points (from 2.08% to 1.99%). As a result, the banks' weighted average interest rate spread widened by 31.6 basis points to 6.08% from 5.77% in February 2018. The weighted average lending rate rose over the past 6 months due to higher business lending rates mainly for lending to the agricultural, professional & other services, tourism, and manufacturing sectors. The decline in the weighted average deposit rate was due mainly to lower demand deposit interest rates.

Similarly, the weighted average lending rate increased by 24.7 basis points while the weighted average deposit rate fell by 9.9 basis points. This widened the weighted average interest rate spread by 34.6 basis points. The weighted average lending rate rose due to higher lending rates for businesses mainly the mining & quarrying and agricultural sectors. However, the low-interest rates from Government Development Loans (GDL) scheme facilitated by the Tonga Development Bank partially supported the higher lending in the business sectors.

Figure 20: Weighted Average Interest Rates Spread



The lower weighted average deposit rate over the year was due to lower rates on all deposit categories reflecting the continued high liquidity in the banking system. Time deposit rates declined the most by 13.5 basis points, followed by demand and savings rates with 8.6 basis points and 1.1 basis points respectively. Nevertheless, the volume of total deposits rose over the year coinciding with the rise in the foreign reserves.

Figure 21: Deposit Rates

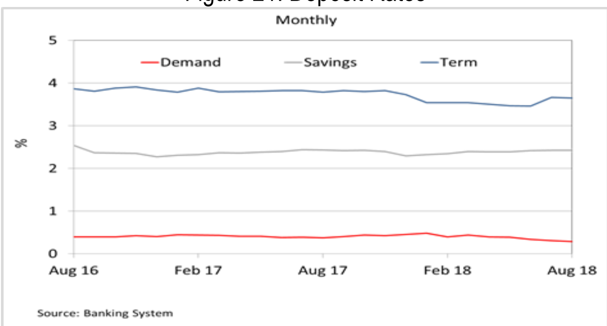


Table 5: Lending Rates
Weighted average of all banks

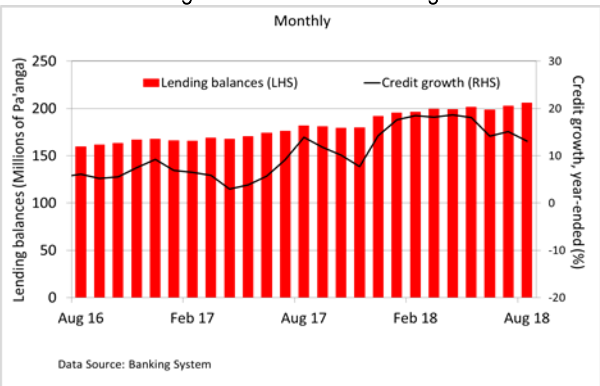
	Level as at			Change over 6 months to		Loan share	
	Aug 18	**Feb 18**	**Aug 17**	**Aug 18**	**Feb 18**	**Aug 18**	**Feb 18**
	%p.a.	**%p.a.**	**%p.a.**	**Bps**	**Bps**	%	%
All	8.08	7.85	7.83	22.33	2.42	100	100
Housing	8.19	8.10	8.10	8.78	-0.06	43	43
Other personal	11.39	11.34	10.97	4.52	36.89	13	13
Business*	7.74	7.26	6.82	48.42	43.85	28	28
Other	6.25	6.25	6.54	0.0	-28.88	16	16

*Included Statutory Non-financial Corporation and Other Financial Corporations

Lending

In August 2018, the total banks' lending reached its highest point ever of $457.5 million, compared to $439.5 million recorded in February 2018 and $415.6 million in August last year. Over the 6 months to August 2018, the rise in total lending was attributed mainly to a $9.6 million (4.9%) increase in business loans and a $8.5 million (3.5%) growth in household loans. GDL accounted for 2.0% of the total loans, compared to a 1.9% share in February 2018.

Figure 22: Business Lending

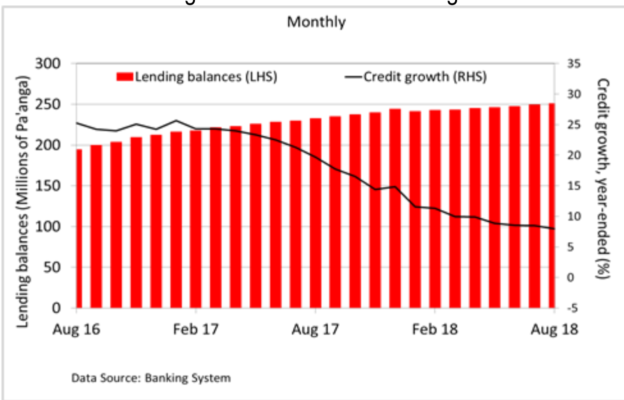


Higher lending to businesses was mainly for the agriculture, wholesale & retail, transport and construction sectors. This reflected the squash planting season which commenced in June and also the on-going economic activities during the reporting period such as the Heilala festivities, church conferences, family Sundays and family reunions. These were also supported by the rise in container registration by 732 containers, reflecting the in-kind donations following the TC Gita. The imports of construction material rose by 63.1% as well as lower lending rates for ongoing construction projects over the 6 months period which also supported the upward trend. Other business developments are yet to be completed such as the Kongakava Boutique Hotel in the tourism sector.

Over the 6 months to August 2018, the higher lending to households was driven significantly by housing loans supported by increases in other personal and vehicle loans. This continued to indicate the consistent demand for housing loans by individuals and for reconstruction of TC Gita damages. Household loans recorded its new high record of $251.1 million in August 2018, increasing by $8.5 million (3.5%) from $242.6 million recorded in February 2018.

Over the 6 months to August 2018, new loan commitments however declined by $8.0 million to $84.7 million. This was attributed mainly to a decline in new loan commitments for the wholesale & retail and tourism sectors and also to public enterprises. This is a similar trend to previous years due to the high loan commitments in November and December of every year to cater for the festive season.

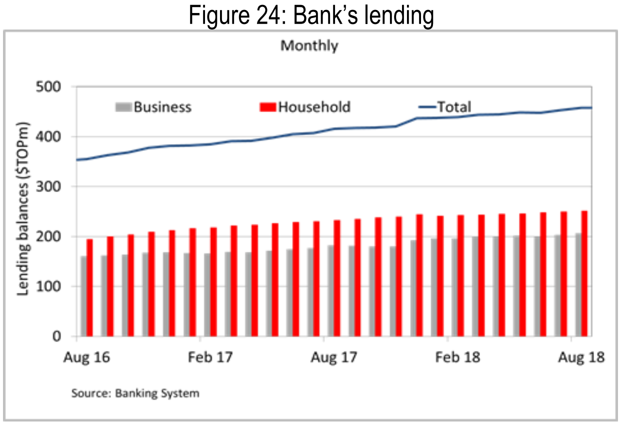
Figure 23: Household Lending



The total banks' lending rose by $41.9 million (10.1%) over the year, due to increases in lending to both businesses and households by $23.9 million (13.1%) and $18.9 million (8.0%) respectively.

Lending to businesses were mainly for public enterprises, wholesale & retail, tourism and construction sectors, indicating growth and investment by businesses in these sectors. The lower interest rates from the GDL scheme also supported these sectors' developments.

Figure 24: Bank's lending



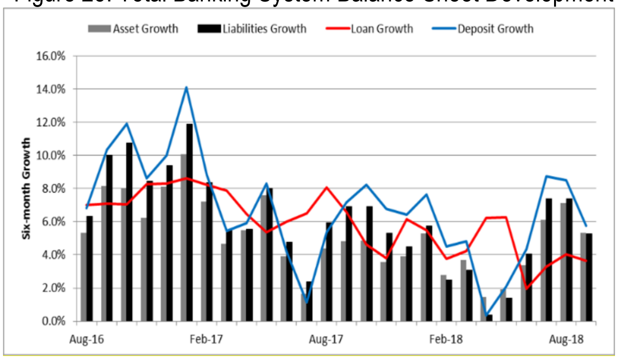
Higher lending to households was mainly for housing and vehicle loans. Both these loans increased by $21.4 million (12.5%) and $0.1 million (1.6%) respectively. Other personal loans, on the other hand, slightly declined by $2.9 million (4.9%) over the year as borrowers paid down their loans.

Lending activities of the non-bank financial institutions[5] also increased over the year by $19.9 million (13.8%). Lending to households increased by $21.6 million (23.5%) offsetting a fall in Government on-lent loans.

Banking System Performance

The banking system remained sound during the six months to August 2018. Total assets of the banking system increased by $57.5 million (7.1%) to $886.7 million over the six months to August 2018. This was due mainly to a 20.3% ($32.5 million) growth in banks' exchange settlement accounts (ESA). This was followed by credit growth since February 2018 of $17.4 million (4%). Similarly, total liabilities increased by 7.4% ($48.5 million) to $704.5 million which was largely attributed to a 8.5% ($48.9 million) increase in total deposits over the past six months to August 2018, mainly demand deposits.

Figure 25: Total Banking System Balance Sheet Development

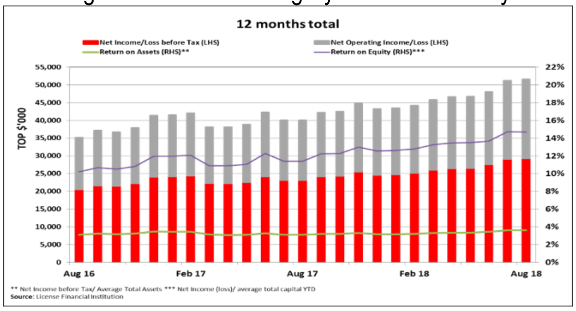


The total banking system remained profitable over the year to August 2018. The Net Profit After Tax was $22.3 million, increasing from $19.1 million in February 2018, and $16.9 million in August last year. The ongoing improved profitability was driven by the increase in interest income from the continuous growth in banks' loan portfolio and the lower non-interest expense and the decrease in provisioning expenses over the last six months.

Return on Assets (ROA) and Return on Equity (ROE) increased over the past six months. The ROA was 3.6%, an improvement from 3.2% in February 2018, as profitability continued to improve. ROE also rose to 14.7% from 12.8% in February 2018 driven by improved profitability of the banks over the 6 months up to August 2018.

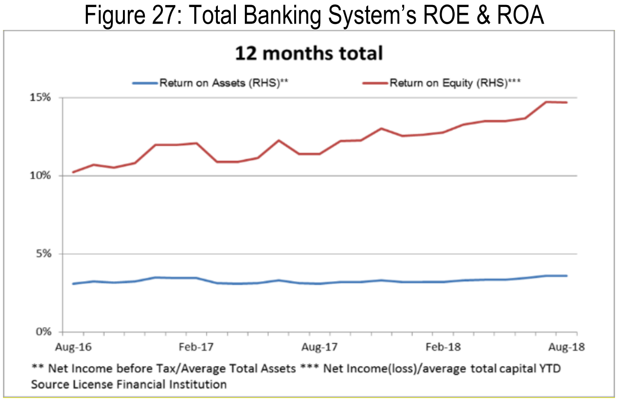
The banking system's capital position remained strong

Figure 26: Total Banking System's Profitability



as the risk-weighted capital ratio was at 28.8% in August 2018 which continued to remain well above the Reserve Bank's minimum requirement of 15%, despite falling from 30.5% in February 2018. The lower risk-weighted capital ratio reflected the increase in risk-weighted assets outweighing the slight increase in capital over the 6 months to August 2018. This was coupled with the improved profitability for banks up to August 2018. The banks' net interest margin increased to 3.4% in August 2018 from 3.2% February 2018. This continued to reflect an increase in interest income as weighted average spread widened due to higher lending rates and lower deposit rates over the six months.

Figure 27: Total Banking System's ROE & ROA

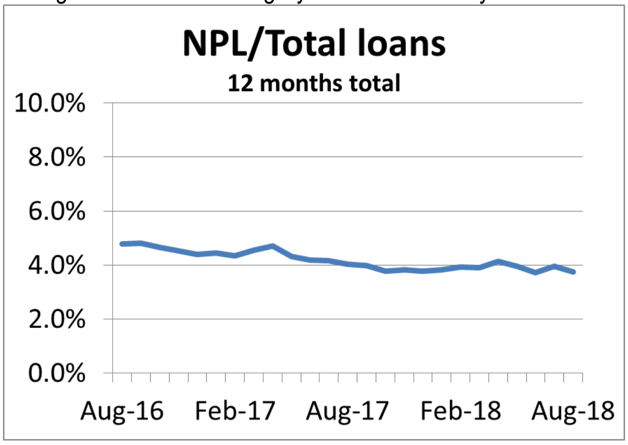


The overall quality of the banks' assets improved over the past six months to August 2018. Total non-performing loans was at $16.8 million slightly declining from $16.9 million, which represented 3.8% of total loans compared to 3.9% in February 2018 and 4% a year ago.

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

The non-performing private individual loans grew to 60.2% of total non-performing loans, from 51.2% six months ago and 44% same time last year. Non-performing private individual loans comprised mainly of housing loans representing 46% of total non-performing loans increasing from 36% in February 2018 and 30% in August 2018. This was attributed to the rise in non-performing housing loans for one of the small banks driven by migration and borrowers that are on study leave.

Figure 28: Total Banking System Asset Quality Indicators



Provisions against loan losses slightly fell over the last six months from $14.0 million to $13.8 million in August 2018 reflecting mainly the upgrade of some of the non-performing loans. Pursuant to Prudential Statement 2 Credit Risk Grading System paragraph 26 requires banks to provide specific provision for non-performing loans net of security value with ALL banks generally compliant in August 2018.

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

Outlook

The Reserve Bank anticipates credit to grow by 13% in 2018/19. Seasonal festivals and cultural obligations coupled with the ongoing business investments will continue to support credit growth. The excess liquidity in the banking system remains indicating available capacity for further lending by banks. However, the top depositor in the banking system is now opting for overseas investment may have an impact on the liquidity in the banking system. At the same time, on-going structural reforms to improve the credit environment such as improvement to the land administration system and a bankruptcy law would improve the confidence of the banks to lend prudently. Furthermore, the continuous improvement in business confidence and improving economic conditions are anticipated to support credit growth. Broad money is also projected to increase in June 2019 by 10%, supported by the anticipated rise in lending and the foreign reserves. The Reserve Bank will continue to closely monitor the rate of growth in credit and broad money to ensure financial and macroeconomic stability are maintained and closely monitor economic developments for any sign of overheating in the economy. Non-performing loans are also likely to decline in the near future.

Supervision of Non-Bank Financial Institutions (NBFIs)

The supervision and oversight of all non-bank financial institutions remains work in progress. The new legislations for the supervision of money lenders, microfinance institutions and the Foreign Exchange dealers have been gazetted on 10th July 2018. The Foreign Exchange Control Act became effective in July 2018 whereas the Moneylenders Act and the Microfinance Act will come into force on a date to be proclaimed by Cabinet. Work is in progress 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.

New reporting templates were issued to the non-bank financial institutions including the Insurance Companies, Foreign Exchange Dealers, Retirement Funds, and Microfinance Institutions to commence reporting on the month of August 2018. These reporting templates were issued following consultation with the respective NBFIs during technical training in July 2018. The NBFIs' comments were incorporated into these reporting templates. Even though only the Foreign Exchange Dealers and Microfinance Institutions have legislations in place, the other non-bank financial institutions were still willing to co-operate and submit information to the Reserve Bank as part of building the regulators' understanding of the industry and their operations.

6. Fiscal Indicators

The fiscal position has slowed over the six months to August 2018, but overall broadly positive. The net credit to Government from the banking system data rose by $9.8 million (5.9%), compared to a $53.2 million (47.5%) decline in the previous 6 months to February 2018. This was due to a decrease in Government deposits which reflected the tax exemptions for six months following TC Gita in February for food items and construction materials. Some of the tax introduced in July 2017 was removed in July 2018 specifically tax levied on the price of chicken. In addition, the delay in budget support receipts that was budgeted to be received before June 2018 may have contributed to this lower level of deposits.

In year ended terms, net credit to Government decreased by $43.4 million (38.8 %), due to a $40.4 million (29.3%) rise in Government deposits. The receipt of some of the budgetary support, grants and cyclone relief funds from development partners and higher remittances during the financial year largely contributed to this increase.

The 2017/18 Government revised budget estimates expected the receipt of $31.4 million in budget support from development partners, however, only $14.4 million was received before the end of June 2018. The 2018/19 Government Budget indicated a Government Finance Statistics (GFS) fiscal balance of $1.3 million of net lending.

Total receipts of $43.5 million of budget support funds are also expected to be received in 2018/19 from development partners. Majority of the budget support funds are anticipated to be received from the World Bank and the Asian Development Bank. The budget support funds estimated for 2018/19 is projected to be received before the end of the 2018/19 fiscal year.

The total public debt position for June 2019 is estimated to represent 51% of GDP, of which 45% is external debt and 6% is domestic debt. This is in line with one of the three fiscal targets in the Government of Tonga Fiscal Strategy for 2018/19, 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 gradually decline towards 50% over time. The external debt service is projected by the Reserve Bank to rise significantly to over $20 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 repayments 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.

On the outlook, Government receipts are expected to rise in the near term due to the budget support to be received for the year 2018/19. This would contribute to the Reserve Bank's projection for foreign reserves to remain at comfortable levels to June 2019.

Net credit to the Government is also anticipated to decrease as a result of expected Government 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 the principal amount to EXIM Bank of China and the projected expenditure in the Government's 2018/19 budget statement, 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

In the past six months to August 2018, the Reserve Bank maintained its accommodative monetary policy stance. Inflation eased in August 2018, foreign reserves were at a comfortable level above the minimum of 3 months of import cover, exchange rates were competitive, the financial system remained sound as it maintained strong capital and liquidity position, and the domestic economy grew strongly as expected. The stability of the financial system continued with no signs of overheating despite the strong credit growth over the year and excess liquidity remains in the banking system. The banks' loans/deposit ratio remained below the 80% loan to deposit target which indicates excess liquidity in the financial system.

The Reserve Banks' outlook for strong domestic economic activity remains in the medium term. The level of foreign reserves is expected to remain at comfortable levels well above the minimum of 3 months of import cover supported by expected higher receipts of budgetary support and grant funds from development partners and anticipated higher receipts of remittances. This will be partially offset by the projected rise in imports and the Government's external loan repayments.

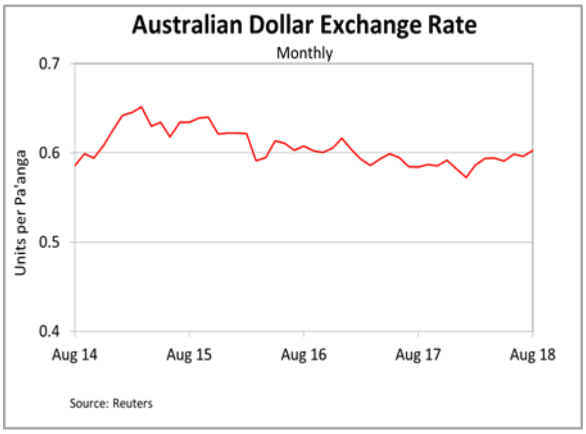
Inflation is expected to fall below the Reserve Bank's inflation reference rate of 5% per annum at the beginning of 2019.

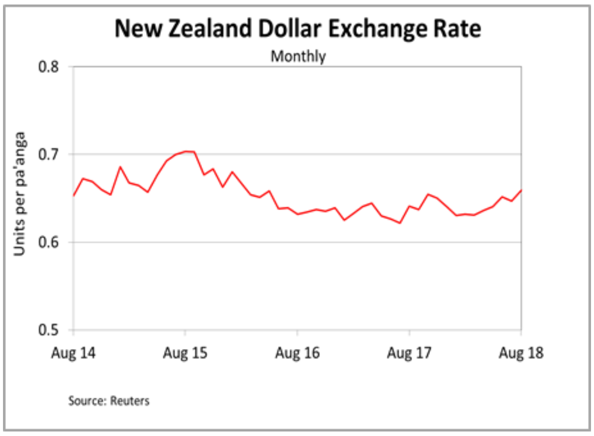
Given the recent developments and the outlook on the monetary policy targets, the current monetary policy stance is considered appropriate in the medium term. Therefore, these monetary policy measures will remain unchanged in the medium term in order to encourage the utilisation of the excess liquidity 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.

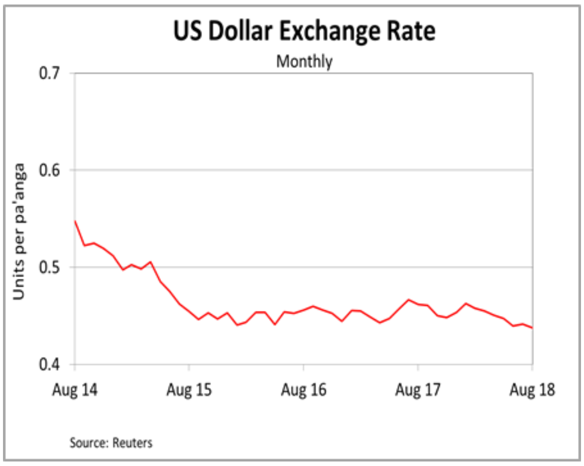
- ✓ Maintain the monetary policy rate (interest rate on banks' exchange settlement accounts or excess reserves) at 0% (zero interest rate policy);
- ✓ Maintain the minimum loans/deposit ratio at 80%;
- ✓ Maintain the Statutory Reserve Deposit ratio at 10%;
- ✓ Maintain the inflation reference rate at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

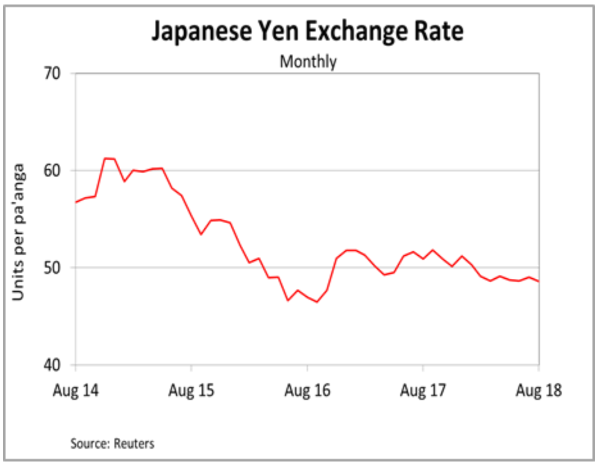
The Reserve Bank will remain vigilant and continue to closely monitor developments for early signs of vulnerabilities which may indicate overheating of the economy. Furthermore, the Reserve Bank will continue to closely monitor developments in the domestic and global economy, and update its monetary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

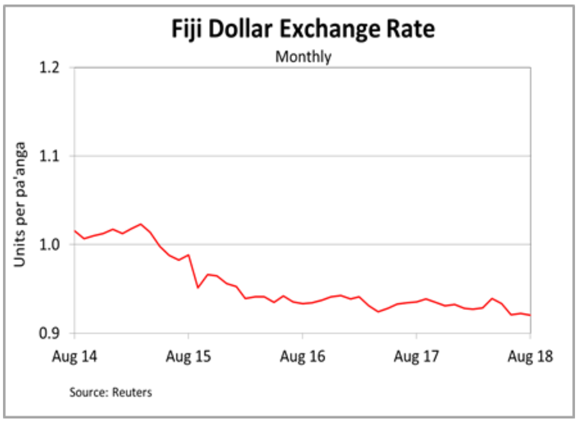
Appendix 1: Tongan Pa'anga Exchange Rates

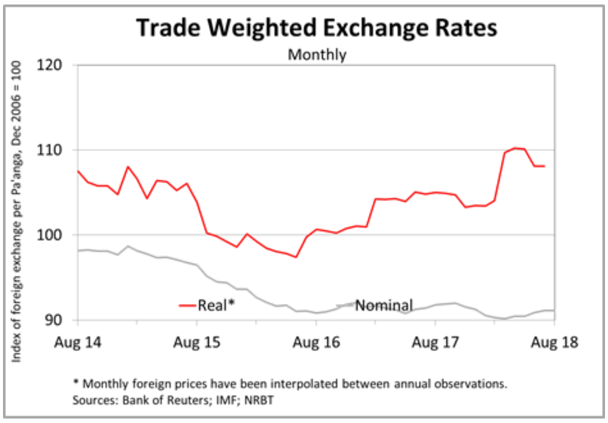












Appendix 2: Monetary Policy Objectives

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 by 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.