National Reserve Bank of Tonga

Annual Report for the Year Ended 30 June 2006

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Discrepancies between the sum of the constituent items and the total, as shown in some tables, are due to rounding. Revisions to previously published statistics are included as they occur.

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PANGIKE PULE FAKAFONUA ‘O TONGA

NATIONAL RESERVE BANK OF TONGA

Private Bag No.25
Post Office
Nukuʻalofa, Tonga
South Pacific

29 September 2006

Hon S T T ‘Utoikamanu
Minister of Finance
Ministry of Finance
NUKU’ALOFA

Dear Mr Minister

In terms of section 54(1) of the National Reserve Bank of Tonga Act, Cap 102, I have the honour to transmit to you on behalf of the Board of Directors of the National Reserve Bank of Tonga the following:

a) a copy of the annual accounts for the year ended 30 June 2006, certified by the External Auditors;
b) a report of the operations of the National Reserve Bank of Tonga for the year ended 30 June 2006.

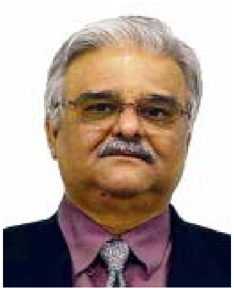
Siosi C. Mafi
Governor

Telephone: (676) 24-057 Facsimile: (676) 24-201 Email: nrbt@reservebank.to Website : www.reservebank.to

Board of Directors of the National Reserve Bank of Tonga as at 30 June 2006

HRH Princess Salote Pilolevu Tuita
Acting Chairperson

Hon. Siosiua T. T. ‘Utoikamanu
Minister of Finance



Mr. Richard Prema

Mrs. Siosi Cocker Mafi
Governor

Principal purposes of the National Reserve Bank of Tonga

“The principal purposes of the National Reserve Bank of Tonga shall be:

(a) to regulate the issue of currency, and the supply, availability and international exchange of money;

(b) to manage the external reserves of the Kingdom;

(c) to promote monetary stability;

(d) to promote a sound financial structure;

(e) to foster credit and exchange conditions conducive to the orderly and balanced economic development of the Kingdom;

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

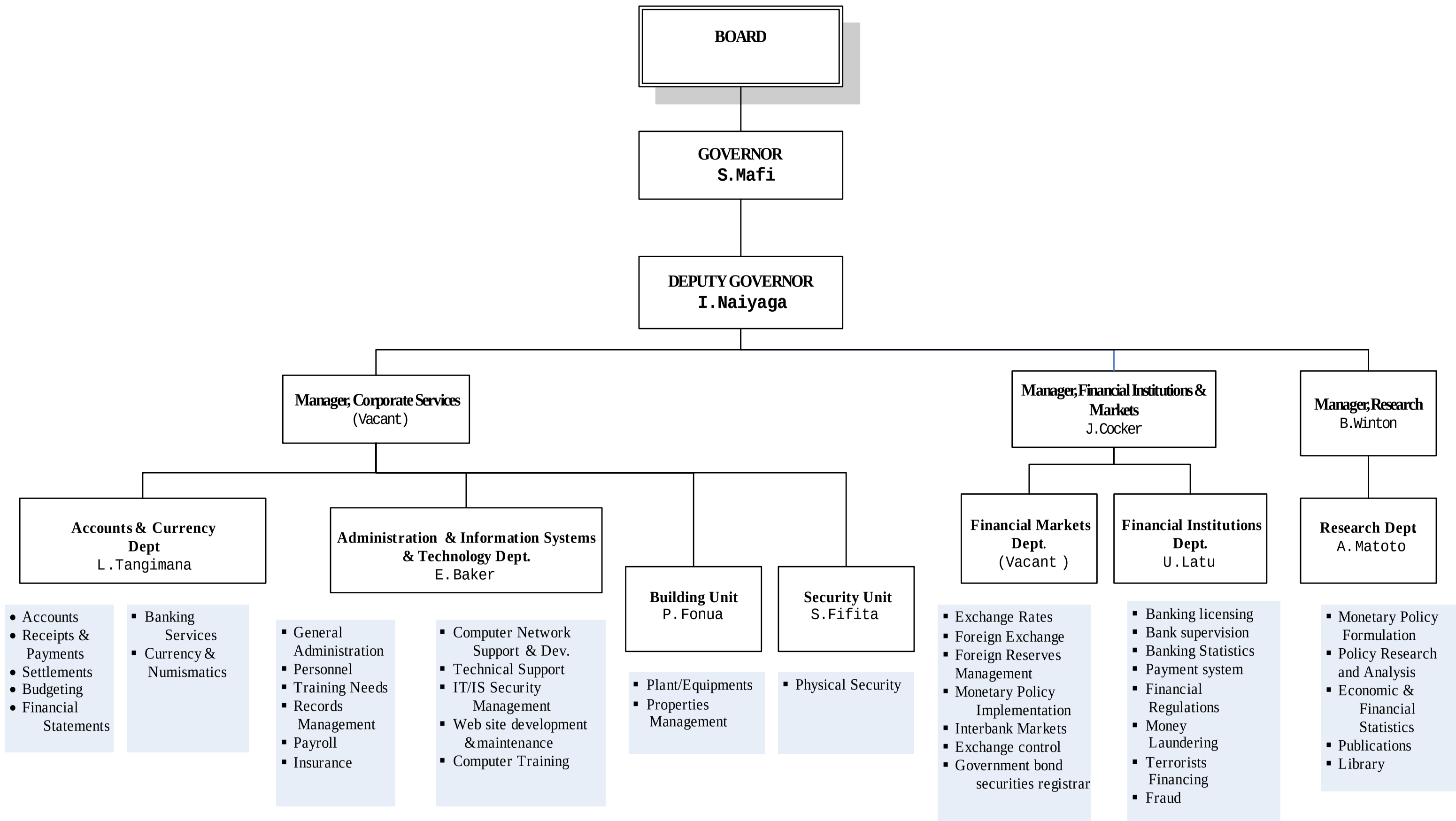
(g) to be the principal banker and fiscal agent of the Government;

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

(i) to undertake the licensing and supervision of financial institutions.”

Section 4
National Reserve Bank of Tonga Act, Cap 102

NATIONAL RESERVE BANK OF TONGA
JUNE 2006



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Governor’ s Forward

The financial year, 2005/06, provided many challenges to conducting monetary policy. Unsustainable growth in credit to the private sector in the first half of the year, a significant increase in salaries awarded to civil servants and a deterioration in the government’s fiscal position posed major risks to macroeconomic stability.

The rapid growth in credit and the increase in the salaries of civil servants contributed to strong growth in imports and placed downward pressure on the level of foreign exchange reserves. The associated strong growth in domestic demand also risked the prospect of higher inflation. It was against this background that the Reserve Bank Board, with the approval of the Privy Council, decided to tighten monetary conditions. Credit ceilings were introduced in January 2006 aimed at slowing the growth of credit and promoting external and internal price stability. Exchange control policies were also tightened.

By the end of June 2006, the policy initiatives appeared to have contributed to stabilising the macroeconomic situation. The pace of credit growth slowed markedly, foreign exchange reserves remained above the Reserve Bank’s target of 3-4 months of imports, the currency remained stable, and inflation trended downwards.

Nevertheless, the economic effects of the increase in the salaries of civil servants and the payment of redundancies are yet to be fully realised. Imports are expected to grow firmly in 2006/07 and exports are expected to remain stagnant with adverse implications for foreign exchange reserves and external price stability. Inflation is also forecast to rise from present levels. Given this outlook, the Reserve Bank in consultation with the banks decided in June 2006 to extend the credit ceilings for another six months. The ceilings for December allow for an expansion of credit that is consistent with promoting external and internal price stability. Special consideration for exemptions to the ceiling would continue to be given for loans to foreign exchange-earning sectors and for loans fostering balanced economic growth. Furthermore, the repayment of a large amount of private individual loans from the government redundancy and salary arrears payments would provide extra scope for the banks to extend credit.

In November 2005, the Board approved the reintroduction of Reserve Bank Notes to improve the management of liquidity in the banking system. Market conditions did not warrant the issue of Reserve Bank Notes until March 2006 when the Required Reserves Ratio was reduced to 12.5 percent from 15 percent. The use of open market operations has always been the preferred instrument for managing liquidity in the system but the high cost prompted the Bank to discontinue the issue of Reserve Bank Notes in 2001. The Reserve Bank’s capital position has improved over the past 5 years and has enabled it to re-commence the issue of Reserve Bank Notes.

The year was also eventful on the banking supervision front. The Financial Institutions Act 2004 became effective, bringing the licensing and supervision of financial institutions into conformity with the Basel Core Principles for Effective Banking Supervision. The new Act assigns the athority for licensing of financial institutions to the Reserve Bank. As such, existing financial institutions were issued with a banking license under the new Act. This new Act strengthens the supervisory role of the Reserve Bank by tightening requirements on statistical reporting, as well as providing legal backing for the establishment of prudential standards. Indicators of banking system soundness were strong, with capital ratios above minimum required levels and a fall in non-performing loans to the lowest level in nearly a decade.

Progress was also made in the area of combating money laundering and terrorist financing. In July 2005, Tonga was formally welcomed as a member of the Asia Pacific Group on Money Laundering, reflecting Tonga's commitment to support global movements towards combating money laundering and terrorist financing.

The Reserve Bank continued to carry out other functions that contribute to monetary and financial sector stability. These functions included the management of the supply of the Tongan currency, provision of daily settlement for inter-bank transactions, undertaking foreign exchange operations with the government and the banks, foreign exchange control administration, and registrar of government bonds.

The Reserve Bank commissioned Pricewaterhouse Coopers, Fiji to undertake a generic review of the Bank's salary structure against 5 major organisations including the government's post-wage settlement salary structure. This ensured that the Bank's salary structure remained within the salary range of these large organisations. The Bank continued to enhance the skills base of the staff through training. Staff participated in courses across the range of central banking functions, attending workshops relating to financial programming, bank supervision, anti-money laundering and information technology.

The annual set of accounts of the Reserve Bank for this year adopted and complied with the requirements of the International Financial Reporting Standards (IFRS) with the exception of the treatment of foreign currency gains and losses, where it will continue to comply with the provisions of the National Reserve Bank of Tonga Act.

I thank the staff of the Reserve Bank for their dedication and hard work in what has been an eventful year. I also thank the members of the Board for their continued support during the year. The assistance from the International Monetary Fund, the Reserve Bank of Australia, the Reserve Bank of New Zealand, Reserve Bank of Fiji, other regional central banks, Bank of England, Pacific Technical Assistance Centre, AusAID, NZAid, AUSTRAC, and AMLAT is also gratefully acknowledged.

Siosi C. Mafi

Governor

Economic Overview

Overseas Economic Developments

The past year saw continued strong global economic growth, with 2006 forecast to be the fourth year of growth above 4 per cent. The expansion in activity also broadened beyond the main engines of the United States and China, to Japan and Europe. Headline inflation increased in many industrialised countries in response to marked increases in the prices of oil and non-fuel commodities. Monetary policy was tightened in many countries, including the United States, the Euro area and China, reflecting emerging capacity constraints and heightened inflationary pressures. Underlying inflation, which excludes food and energy prices, also edged higher, though remains generally contained. In financial markets, long-term bond yields rose in response to the robust global economic growth and associated inflationary concerns, as well as expectations of tighter monetary policy.

The pace of growth in the United States was solid in 2005/06, though it moderated towards the end of the year, reflecting a softer housing market, the restraining influence on demand of higher energy prices and the lagged effect of past increases in interest rates. The Federal Reserve increased the fed funds by 2 percentage points to 5.25 per cent by the end of June 2006. Growth is expected to remain at a moderate pace, with further increases in fuel prices and a sharp downturn in the housing market representing the main downside risks to economic growth.

Table 1: INTERNATIONAL ECONOMIC INDICATORS

	Real GDP Annual percent			Consumer Prices Annual percent change			Current Account Balances Percent of GDP		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
United States	3.2	3.4	2.9	3.4	3.6	2.9	-6.4	-6.6	-6.9
Japan	2.6	2.7	2.1	-0.6	0.3	0.7	3.6	3.7	3.5
Euro area	1.3	2.4	2.0	2.2	2.3	2.4	0.0	-0.1	-0.2
China	10.2	10.0	10.0	1.8	1.5	2.2	7.2	7.2	7.2
Australia	2.5	3.1	3.5	2.7	3.5	2.9	-6.0	-5.6	-5.3
New Zealand	2.3	1.3	1.7	3.0	3.8	3.4	-8.9	-9.6	-9.1

Source : IMF World Economic Outlook, September 2006

Economic growth in China continued to be robust, driven by strong growth in exports, business investment and consumer spending. The associated rise in credit prompted the central bank to tighten financial conditions in several stages. Economic growth is expected to remain rapid in 2007. Elsewhere in Asia, strong demand from China, as well as solid domestic demand, underpinned a pick-up in growth. Increasing inflationary pressures prompted the central banks of South Korea, Thailand and Taiwan to increase official interest rates. The Japanese economy continued to strengthen, with growth of around 3.0 per cent in 2005/06, the fastest pace in at least 10 years. In response to the sustained growth and a rise in consumer prices, the Bank of Japan announced an end to the quantitative easing in policy and the return to using the short-term interest rate as the operating target for monetary policy.

The Australian economy expanded solidly in 2005/06, against the background of substantial increases in commodity prices. A favourable business climate, higher commodity prices and buoyant profitability contributed to rapid growth in business investment. Emerging capacity constraints and rising inflationary pressures prompted the Reserve Bank of Australia to tighten policy by 25 basis points. By the end of the year, the Bank's measure of underlying inflation was edging towards 3 per cent, the upper limit of the 2-3 per cent inflation target.

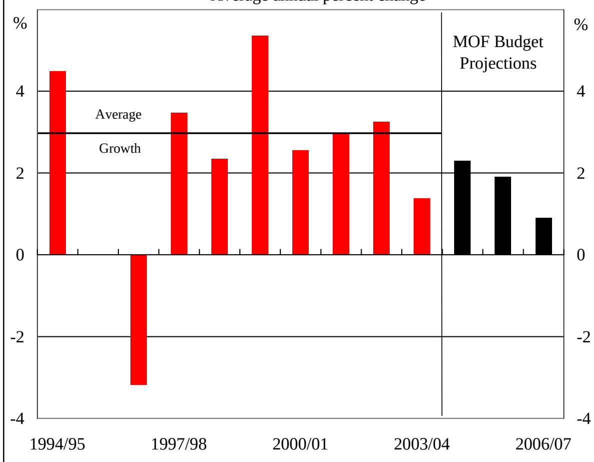
In New Zealand, GDP growth moderated in 2005/06, largely reflecting a slowdown in private consumption. Significant increases in fuel prices, the effects of previous tightenings in monetary policy and a softer housing market were the main contributing factors. Net exports also remained under pressure due to the high value of the NZ dollar throughout much of 2005. Interest rates were raised in the second half of 2005, with the Reserve Bank of New Zealand citing capacity constraints and continuing strong inflationary pressures as factors in its decisions. Headline inflation remained above the 1-3 per cent inflation target throughout the year.

In the Pacific region, a number of countries faced similar macroeconomic challenges to Tonga. While economic conditions were mostly positive, strong growth in imports and sluggish export performances resulted in a deterioration in the balance of payments. This environment prompted several central banks to tighten monetary policy to promote external balance. These trends were particularly evident in Fiji, where the Reserve Bank of Fiji tightened monetary policy in three stages in 2005/06 in order to slow the growth of credit and protect the level of foreign exchange reserves. The Central Bank of Samoa also tightened monetary conditions, citing a forecast large balance of payments deficit and a substantial reduction in official reserves as factors behind the decision.

Domestic Economic Conditions

Economic growth is estimated by the Ministry of Finance to have eased from 2.3 per cent in 2004/05 to 1.9 per cent in 2005/06, which is slightly below the average pace of the past ten years (Figure 1).

Figure 1: Gross Domestic Product
Average annual percent change



Source: Statistics Department and Ministry of Finance

A slowdown in construction activity, reflecting the completion of several major non-residential building projects and an easing in dwelling construction, was the main factor behind the softer growth. Nevertheless, construction remained at a high level, with activity expanding by 2 per cent following a 15 per cent rise in 2004/05. Non-residential construction work was underpinned by the Solid Waste Management project, EU projects in Vava'u relating to health and education and the solar electrification project in Niuafo'ou. Work also continued on the extensions to the Vaiola Hospital. While growth in lending for dwelling construction slowed from the rapid pace in 2004/05, outstanding housing loans at the end of June 2006 were still 22 per cent higher than a year earlier, underpinning a continued high level of construction activity.

Table 2: TONGA MAIN ECONOMIC INDICATORS

		2002/03	2003/04	2004/05	2005/06
Economic Activity					
Real GDP	% change	3.2	1.4	2.3	1.9 (e)
Tourist Arrivals	Thousands	44.5	43.6	51.9	57.4 (e)
Money, Prices & Interest Rates					
CPI (average annual)	% change	10.7	11.8	9.9	7.2
CPI (year end)	% change	12.3	10.1	8.7	6.4
Money Supply (M2 – year end)	$m pa'anga	151.6	180.3	203.5	237.3
Domestic Credit (year end)	$m pa'anga	195.2	174.0	210.3	264.5
Weighted-term deposit interest rate (year end)	% per annum	6.0	6.5	6.0	6.8
External Sector					
Merchandise exports fob (OET basis)	$m pa'anga	38.6	28.3	31.1	32.6
Merchandise imports fob (OET basis)	$m pa'anga	163.0	169.0	204.2	235.6
Official foreign reserves (year end)	$m pa'anga	36.9	89.7	82.1	83.2
Import coverage (year end)	Months	2.4	5.4	4.4	4.1
Exchange rate (period end)	US$/T$	0.466	0.501	0.520	0.485

Sources: Ministry of Finance Budget 2006/07, Tonga Visitors Bureau, Statistics Department and National Reserve Bank of Tonga

Squash pumpkin processing

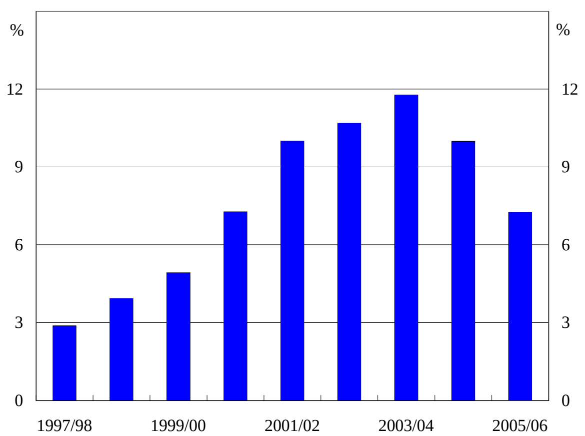
Seaweed processing at local factory

Agricultural output, which comprises nearly a quarter of GDP, again fell, though by less than in 2004/05. Trade data suggests that production of squash, Tonga's main cash crop, as well as root crops, vanilla and kava were subdued. Output from fishing and other marine products, such as seaweed, were also low. Credit data suggests little additional investment in the fishing industry.

The commerce, hotels & restaurants sector, which includes retailing and wholesaling, as well as many tourist activities, grew firmly in 2005/06, reflecting strong growth in household credit, the effects of higher salaries paid to civil servants in November 2005 and an increase in tourist arrivals. Surveys conducted by the Reserve Bank reported solid growth in vehicle sales and turnover at supermarkets.

Growth in transport & communications picked up firmly, partly reflecting the entry of a second domestic airline, Airlines Tonga, and an international carrier, Pacific Blue, in late 2005. Strong growth in air arrivals, which includes returning nationals were reported from Australia, New Zealand and the United States.

Figure 2: Consumer Prices
Average annual percentage change



Source: Statistics Department

Prices

Headline inflation as measured by the Consumer Price Index (CPI) continued to fall in 2005/2006. The CPI rose by 6.4 per cent in the year-ended June 2006, well down from the 8.7 per cent rise in the year-ended June 2005. Average annual inflation in 2005/06 was 7.2 per cent, the lowest level in six years and down from 9.9 percent in the previous year (Figure 2).

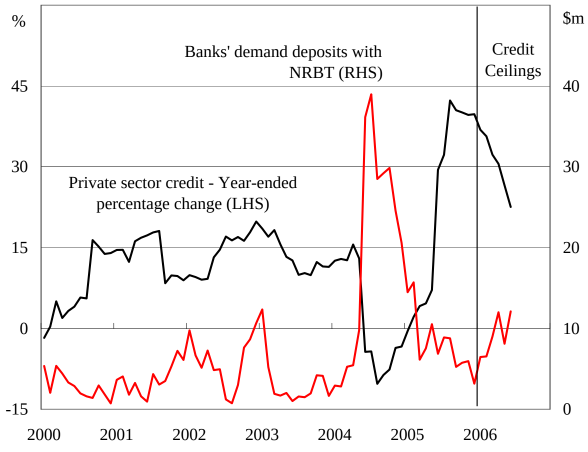
Domestic and imported items both contributed to the fall in inflation, particularly domestic food and imported tobacco & alcohol prices. The fall in domestic food price inflation from 18 per cent to around 6 per cent, largely reflected favourable weather conditions and the plentiful supply of fruit & vegetables. A reduction in excise duty in July 2005 resulted in a fall in the price of imported cigarettes. Higher world oil prices, which rose over the year from just above US$50 per barrel to around US$70 per barrel was the main factor contributing to inflationary pressures. The category, imported transportation, which largely comprises oil-related products, contributed around 2½ percentage points to the 6.4 per cent inflation rate in June 2006.

In the Government's 2006/07 Budget, the Ministry of Finance forecast an increase in inflation to 10 per cent in the first half of 2007. The redundancy payment of civil servants paid on 30 June 2006 will boost domestic demand, while the payment of salary arrears at the beginning of the 2006/07 financial year will have flow-on effects to private sector wages as well as adding to domestic spending. The lagged indirect effects of past world oil price increases, both in Tonga and abroad are also yet to be fully realised. Underlying inflation in Tonga's major trading partners increased over the past year, so further gains in reducing inflation from lower growth in imported prices will be difficult.

Financial Intermediation

An improvement in the government's net credit position with the banking system and the offshore refinancing of a large domestic exposure in 2003/04 resulted in a significant increase in liquidity in the banking system. This underpinned strong growth in domestic credit to the private sector (Figure 3).

Figure 3: Banking Sector Liquidity and Private Sector Credit



Source: National Reserve Bank of Tonga

Intense competition amongst the banks also contributed to the strong growth in lending, initially to the household sector, and later to the business sector. By the first half of 2005/06, year-ended growth in credit to the household sector was running at an unsustainable 48 per cent. The payment of the first tranche of the civil service pay increase in November 2005 added to the borrowing capacity of households, contributing to a spike in lending to households the following month. Most of the lending to households was for housing and to a smaller extent, other personal purposes. Lending to the business sector picked up towards the end of 2004 and by the second half of 2005, annual growth was above 30 per cent. Business lending was broadly based across agriculture, wholesale & retail, hotels & restaurants and other services.

The increase in lending in 2005/06 was largely funded by a rise in broad money, particularly term deposits, which increased by 27 per cent, as banks sought to lock in long-term funding. At the end of June 2006, saving deposits, which had shown little net change throughout much of the year, jumped by a third, reflecting the redundancy payments to retiring civil servants.

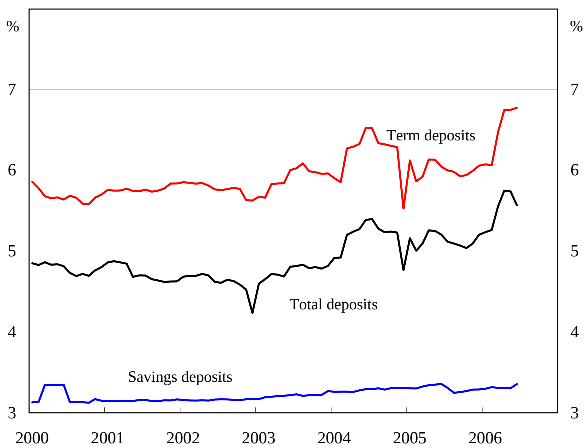
The unsustainable strong growth in credit resulted in very tight liquidity positions for some of the banks. To dampen the unsustainable pace of lending, protect the level of foreign exchange reserves and preserve the gains on reducing inflation, the Reserve Bank imposed credit ceilings in January 2006. This move appeared to be successful. By the end of 2005/06, year-ended growth in private sector credit had fallen to 23 per cent. The extension of the credit ceilings to December 2006 is expected to lead to a further slowing in credit growth to a pace more consistent with long-run nominal GDP growth.

The government's net credit position with the banking system improved for much of the year, reflecting better than budgeted tax revenues. At the end of June 2006, the payment of redundancies to retiring civil servants totalling $21.2 million resulted in the net credit position of the government falling to the lowest level since October 2004.

Interest Rates

Interest rates were relatively stable in the first half of 2005/06, reflecting the lingering overhang of liquidity in the financial system. By early 2006, financial conditions had tightened considerably, mainly reflecting the strong growth in lending over the previous six months and lower-than-expected receipts from squash exports. The anticipation of the payments of civil service redundancies and the second tranche of the civil service salary increase from government deposits with the banking system heightened the need for banks to increase their liquidity levels. This underpinned strong competition amongst the banks for funds. By the end of June, the Reserve Bank's term deposit indicator rate, a weighted average of interest rates paid by commercial banks, rose to 6.8 per cent, up from 6.0 per cent a year earlier (Figure 4). The lending indicator rate, a weighted average of interest rates across household and business lending, rose from 11.5 per cent to an historic high of nearly 12.3 per cent.

Figure 4: Weighted Deposit Interest Rates



Source: National Reserve Bank of Tonga

The increase in nominal interest rates and the fall in inflation resulted in real deposit interest rates increasing towards positive territory. The move towards positive real interest rates will encourage savings in financial institutions, thereby enhancing financial intermediation and promoting an environment conducive to economic development.

External Developments

According to overseas exchange transactions data collected from the commercial banks, a substantial increase in imports was offset by an improvement in net capital inflows and the trade in services. The result was a stable level of foreign exchange reserves (Table 3). The trade balance deteriorated in 2005/06, as imports rose by 15 per cent on the back of higher world oil prices and strong domestic demand. Imports of consumer goods and motor vehicles rose substantially, boosted by the payment of the first tranche of the civil service salary increase in November 2005. Throughout the year, strong growth in credit for housing also underpinned a marked rise in the import of construction materials. Exports on the other hand were stagnant, with higher export earnings from fish and other marine products offset by a fall in receipts from squash exports.

Table 3. OVERSEAS EXCHANGE TRANSACTIONS (OET): Annual Summary

	2002/03	2003/04	2004/05	2005/06
A. Merchandise trade balance	-124.4	-140.8	-173.1	-203.0
Exports, f.o.b.	38.6	28.3	31.1	32.6
Imports, f.o.b.	163.0	169.0	204.2	235.6
B. Services balance	-11.9	-5.9	-20.5	-13.1
Receipts	54.8	52.7	44.7	51.5
Payments	66.7	58.5	65.2	64.6
C. Investment income balance	-3.3	-0.8	3.1	5.0
Receipts	4.7	5.6	6.6	9.4
Payments	8.1	6.4	3.5	4.4
D. Transfers balance	128.9	163.1	178.1	178.4
Receipts	151.4	185.7	208.7	205.2
Private	149.6	184.4	208.1	204.5
Official	1.8	1.3	0.6	0.6
Payments	22.6	22.6	30.6	26.8
Private	20.7	21.9	30.0	26.6
Official	1.8	0.7	0.6	0.1
E. Current account balance (A+B+C+D)	-10.7	15.7	-12.4	-32.7
F. Capital account balance	17.4	75.6	24.2	40.4
Official capital	16.9	28.1	9.4	14.4
Inflows	24.1	33.1	16.2	20.4
Outflows	7.2	5.0	6.9	6.1
Private capital	0.5	47.5	14.9	26.0
Inflows	9.8	56.5	34.2	36.5
Outflows	9.3	9.0	19.3	10.4
G. Other items, net	-9.3	-38.5	-19.5	-6.6
H. Overall balance (E+F+G) [1/]	-2.6	52.8	-7.6	1.1

[1/] Corresponds to changes in gross official foreign reserves.

Totals may not add up due to rounding.

Source: National Reserve Bank of Tonga

Net remittances, the main source of Tonga's foreign exchange earnings, were largely unchanged in 2005/06, reflecting falls in both receipts and payments. In contrast, the deficit on services improved, partly reflecting a rise in visitor air arrivals, while the net balance on investment income remained a modest surplus. These movements resulted in a widening of the current account deficit from around $12 million to $33 million or 7.2 per cent of GDP.

The capital account surplus improved by $16 million to $40 million in 2005/06, reflecting an increase in official capital inflows, mainly foreign aid, and a fall in private capital outflows. The improvement in the capital account and a fall in net unrecorded outflows offset the deterioration in the current account deficit, which resulted in a small balance of payments surplus and a slightly higher level of foreign reserves. However, while official foreign reserves rose to $83.2 million at the end of June 2006, import cover fell to 4.1 months (Table 2). This reflected the strong growth in imports and higher average monthly import payments.

Monetary Policy

The Objectives of Monetary Policy

The NRBT's obligations with respect to monetary policy are laid out in Section 4 of the National Reserve Bank Act, 1988 which states that the principal purposes of the Bank shall be:

- to regulate the issue of currency, and the supply, availability and international exchange of money;
- to manage the external reserves of the Kingdom;
- to promote monetary stability;
- to promote a sound financial structure; and
- to foster credit and exchange conditions conducive to the orderly and balanced economic development of the Kingdom.

In additon, Section 30 of the Act gives the Reserve Bank the responsibility of maintaining an adequate level of foreign exchange reserves.

The Reserve Bank believes that it can best meet its responsibilities relating to monetary policy by maintaining official foreign exchange reserves at an adequate level equivalent to at least 3-4 months of imports and promoting price stability. Maintaining an adequate level of foreign reserves is vital for a small open economy such as Tonga, which is dependent on imports for the supply of most of its goods, as well as for inputs into many domestically-produced goods. These imports must be paid for in foreign currency.

The maintenance of an adequate level of foreign exchange reserves promotes external stability and exchange rate stability. Given the high component of imported goods in the CPI (66 percent), 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 balanced economic development in many ways. Stable prices protect the purchasing power of the currency for consumers and savers. By protecting purchasing power, monetary policy assists the most vulnerable members of society who are generally least able to protect their savings against inflation.

Price stability also contributes to improved economic performance. When inflation is low and stable it is easier for consumers and firms to make decisions relating to consumption, investment and saving. 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.

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

Monetary Policy Formulation and Implementation

There were a number of important developments underpinning monetary policy during the year. Against a background of unsustainable credit growth, strong growth in wages, a forecast fall in the level of foreign exchange reserves and an expected increase in inflation, the Reserve Bank, with the approval of the Privy Council in January 2006, imposed credit ceilings on individual banks' lending to the non-finanical private sector. In June 2006, after consultation with the banks, the Reserve Bank announced the extension of the credit ceilings into the first half of 2006/07. The December ceilings aimed at balancing the need to protect foreign exchange reserves, at the same time, allowing an expansion of credit to facilitate growth in activity. Special consideration for exemptions to the ceiling would continue to be given for loans to foreign exchange-earning sectors and for loans fostering balanced economic growth.

The arrangement for lender of last resort and providing temporary liquidity support to the banking system was enhanced during the year. In February 2006, the Reserve Bank Board approved banks' Statutory Reserve Deposits held at the Reserve Bank to be used as eligible security for borrowing from the central bank. Prior to this decision, security was confined to holdings of Government Bonds and Reserve Bank Notes. Some banks did not hold government bonds and therefore could not access the repurchase facility for temporary liquidity support.

The Reserve Bank also moved towards the use of market-based instruments in the conduct of monetary policy. In March 2006, the Reserve Bank re-issued Reserve Bank Notes to improve the management of liquidity in the banking system. Until then, credit ceilings and reserve requirements were the main instruments used for conducting monetary policy. The advantages of open market type operations are that they allow for greater flexibility in managing liquidity in the financial system and also allow for liquidity to be managed pro-actively. The NRBT initially issued Reserve Bank Notes in 1993, but due to the high cost, refrained from further issues in 2001. The Bank's improved capital position allows Reserve Bank Notes to be again used to manage liquidity.

Tenders for the purchase of Reserve Bank Notes are conducted weekly. The amounts accepted, while initially small, gradually increased. The maturity of the Notes was confined to 28 days, with the average yield increasing in May 2006 from 4.25 per cent to 4.65 per cent. At the end of June 2006, outstanding notes amounted to $1.5 million.

The Reserve Bank Notes played a role in sterilising the effects of the payment of redundancies and salary arrears to government employees and will continue to do so in the coming year.

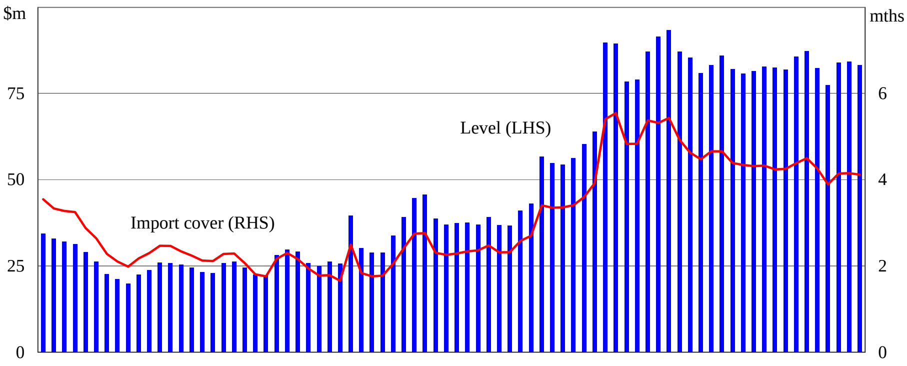
Consistent with the move towards the use of market-based instruments, the Reserve Bank reduced the Required Reserves Ratio from 15 per cent to 12.5 per cent, effective 3 March 2006.

The Reserve Bank's minimum lending rate remained unchanged at 12 percent. The Reserve Bank is currently reviewing its liquidity management policy with the aim of improving the effectiveness and efficiency of its operations.

Achievement of Monetary Policy Objectives

Progress was achieved in meeting the Bank's objective of promoting monetary stability in a very challenging environment. The imposition of credit ceilings contributed to reducing the growth of credit to a more sustainable pace and protecting the level of foreign exchange reserves. Growth in private sector credit eased to 23 per cent in the year-ended June 2006, a significant decline from the 40 per cent growth in much of the second half of 2005. Credit growth is expected to fall further in 2006/07.

Figure 5: Gross Official Foreign Reserves

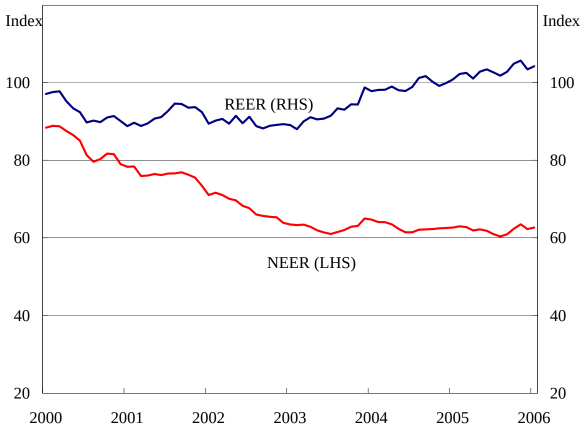


Source: National Reserve Bank of Tonga

Gross official foreign reserves remained above the equivalent of 4 months of imports throughout 2005/06 (Figure 5). At the end of June 2006, the level of gross official foreign reserves amounted to $83.2 million, equivalent to 4.1 months of imports.

The nominal effective exchange rate (NEER) remained relatively stable fluctuating in a range of 60.4 and 63.5 during the year. At the end of June 2006 the NEER fell slightly to 62.4 from 62.7 in June 2005, reflecting the overall movement of the Pa'anga against the basket of currencies over the year where it depreciated against the USD and the AUD and appreciated against the NZD. This would have been a favourable movement to the public at large where the main source of remittances is from the United States and New Zealand being the main source of imports. At the same time, the real effective

Figure 6: Nominal & Real Effective Exchange Rates
January 1991 = 100

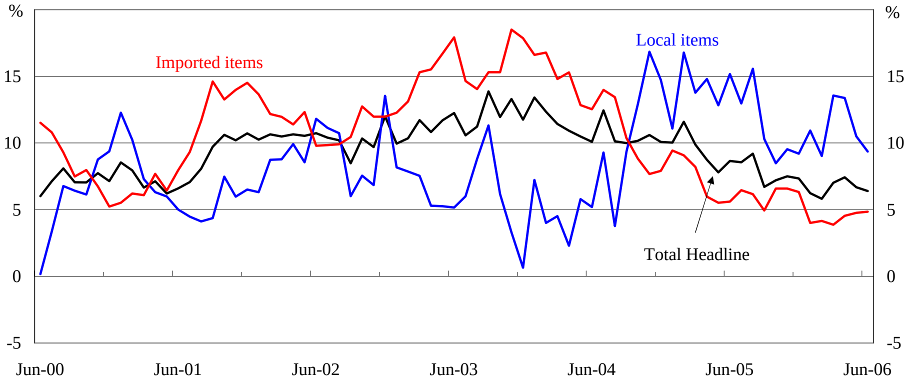


Source: National Reserve Bank of Tonga

exchange rate appreciated by 3 per cent implying that the international competitiveness of Tonga's good and services weakened over the year.

In terms of prices, headline inflation rose by 6.4 per cent in the year-ended June 2006, well down from the 8.7 per cent rise in the year-ended June 2005 and the peak of 13.9 percent in September 2003. This has been a positive outcome, given the increases in world oil prices over the past two years and the significant wage increases paid to civil servants in November 2005.

Figure 7: Consumer Prices
Year-ended percentage change



Source: National Reserve Bank of Tonga

The movement of the total headline inflation reflects the sensitivity of the level of overall prices to prices of imported goods, the level of the exchange rate, the level of prices of domestic food, and government tax measures. During 2005/06, growth in the prices of local items continued to be above the growth of prices in imported items.

The effectiveness of the Reserve Bank's conduct of monetary policy will be enhanced with increased autonomy, accountability and transparency. This would entail a clear separation of objectives and functions, authority to determine and implement monetary policy to achieve its objectives, clearer accountable relationship with the government and the public. If the Reserve Bank is to be in a position to credibly and effectively safeguard the external balance, the medium term purchasing power of the currency and therefore medium-term stability of prices, it needs to be more autonomous in undertaking its monetary policy measures, at the same time be made more accountable and transparent to government and the public in carrying out its functions. The draft amendments to the NRBT Act planned to be tabled in the current sitting of Parliament aims to address these issues.

Transparency of Monetary Policy

During the year, the Reserve Bank continued to work towards improving the transparency and accountability of its conduct of monetary policy. The Reserve Bank usually conducts a bi-annual meeting with banks to discuss policy issues and other operational matters. Given the challenges faced by the economy during the financial year, consultations with the government and the banks were enhanced in order to manage these developments prudently.

The work towards improving transparency and accountability will continue next year with the commencement of the issue of a regular Monetary Policy Statement. This Statement will discuss the conduct of monetary policy in pursuing the objectives of the Bank in the previous period, highlight the issues affecting monetary policy settings and outline the Reserve Bank's intention to conduct monetary policy in the coming period.

The issue of a regular Monetary Policy Statement will be in addition to the current practice of announcing changes to monetary policy and publishing economic commentaries in the Quarterly Bulletin and the Annual Report. These releases are available from the Bank's website.

Reserve Bank presentation of monetary and economic conditions to licensed financial institutions

The Economic Outlook

The economic outlook for 2006/07 is highly uncertain. The Ministry of Finance's 2006/07 Budget forecast economic growth to ease from 1.9 per cent in 2005/06 to 0.9 per cent in 2006/07. The slower growth, which is based on production-based measures of Gross Domestic Product, largely reflects a lower contribution from Government Administration and Services arising from the redundancy of around 820 government employees. In contrast, indicators of domestic demand can be expected to remain buoyant, underpinned by higher levels of spending flowing from the redundancy payments and civil service salary increases. A major uncertainty is the extent to which the payments will be saved, rather than spent. A growing gap between production and expenditure implies that much of the increase in demand for goods and services will be met by imports, i.e. the current account deficit, which was 7 percent of GDP in 2005/06, can be expected to remain large. Unless there are offseting capital inflows, the risks surrounding foreign exchange reserves remain on the downside. Monetary conditions will need to remain firm in order to maintain an adequate level of foreign reserves of at least 3-4 months of imports, as well as to maintain stability in the external value of the currency.

Tonga's high dependence on imports means that ensuring external price stability has an important influence on promoting domestic price stability. Despite the progress over the past year in reducing inflation, the deteriorating inflation outlook provides additional reasons to retain a tightening bias. The civil service salary increase is likely to affect to some extent wages growth in the private sector, while the redundancy payments to retiring civil servants and salary increases provide a significant boost to spending. Supply constraints are likely to be experienced in some industries, notably retailing and wholesaling. The upward pressure on inflation from domestic sources comes at a time when inflation abroad is increasing. This will increase the cost of imported goods and hence local prices. Inflation has risen in many of Tonga's major trading partners, notably Australia, the United States and New Zealand. World oil prices, which have more than doubled over the past two years and is a major component of Tonga's CPI, remains an important upside risk to the inflation outlook.

Apart from the usual weather related risks surrounding the outlook, other risks include the government's fiscal position, the implementation of the government's tax reform program, and the level of squash exports from the 2006/07 season. Central bank financing of the government budgetary position poses a threat to Tonga's macroeconomic stability. The amount of any credit provided by the Reserve Bank to the government must be limited to a level consistent with the macroeconomic stability objectives. The promotion of macroeconomic stability, i.e. external and internal price stability requires complimentary fiscal and monetary policies.

The Reserve Bank's conduct of monetary policy will continue to be motivated by the objectives of protecting the level of foreign reserves and thereby promoting external and internal price stability. This remains the best contribution that monetary policy can make towards improving the welfare, and raising the living standards, of the people of Tonga.

Financial Markets

Open Market Operations

The Financial Markets Department carries out the implementation of monetary policy. In November 2005, the Board approved for the Bank to commence open market operation by re-issuing its Reserve Bank Notes to enhance the management of liquidity in the banking system. At the time, the liquidity in the banking system was relatively tight and the issue of Reserve Bank Notes only began in March 2006 when the Statutory Required Reserves was reduced to 12.5 percent from 15 percent.

The Reserve Bank concentrated on issuing 28 day Reserve Bank Notes by tender on a weekly basis at an average rate that is based on the latest published market rates which ranged between 4.25 percent and 4.65 percent per annum. At the end of 30 June 2006, the outstanding Reserve Bank Notes was T$1.5 million.

The National Reserve Bank of Tonga Act prohibits the Reserve Bank from making unsecured loans to any of its customers. Any borrowing from the Reserve Bank has to be secured by government bonds, NRBT notes or any other security specified by the Board. In 2005/06, the Reserve Bank did not receive any applications and did not enter into any repurchase agreement transactions with licensed financial institutions. The Reserve Bank is reviewing its policy and procedures of liquidity management in 2006/07.

The Financial Markets department also monitors activities in the domestic inter-bank market. The record showed that interbank activities picked up during the 2005/06 financial year. Total loans of $12.35 million were made during the year for maturities ranging from overnight to two weeks compared to total loans of $1.3 million in the previous year. The increase in the total loans in the interbank market reflected the tight liquidity experienced by the banking system. The interest rate charged by the banks for overnight loans remained unchanged at 8 per cent per annum.

Reserves Management

The Reserve Bank is required to maintain, within the limit of its powers, an external reserve at a level of at least 3 to 4 months of imports. During the year the gross official external reserves ranged between 4.1 months and 4.8 months of import cover. The level of gross external reserves ranged from $77.4 million to a peak of $87.2 million at the end of January 2006. At 30th June 2006 the total official external reserves were $83.2 million, equivalent to 4.1 months of imports. This compares with the level of $82.1 million at 30 June 2005, equivalent to 4.5 months of imports. This reflected the strong growth in imports and higher average monthly import payments.

The Reserve Bank holds the external reserves mainly in Australian dollars, New Zealand dollars, US dollars, pounds sterling, euro and special drawing rights. In managing the external reserves, the Reserve Bank's policy is to obtain the maximum income commensurate with safety, liquidity and the maintenance of overall value. Accordingly, the external reserves are invested in deposits with A rated international banks by international credit rating agencies, government securities and deposits with central banks.

Foreign Exchange Operations

The Reserve Bank conducts foreign exchange operations with the domestic commercial banks in the intervention currency only, the US dollar. The Reserve Bank quotes daily buying and selling rates for the US dollar against the pa'anga. These rates generally form the basis of the commercial banks' publicly quoted foreign exchange dealing rates. The Reserve Bank also conducts foreign exchange operations for its other customers, and for its own account, in a range of currencies. The Reserve Bank was a net buyer in the spot foreign exchange markets during the year. Foreign exchange purchases of T$85.5 million exceeded sales of T$84.4 million giving a total foreign exchange turnover for the year of T$169.9 million.

The value of the pa'anga against the USD fluctuated in a range of US$0.49 and US$0.52 in 2005/06, it moved against the AUD between AUD0.65 and AUD0.68 and fluctuated against the NZD between NZD0.70 and NZD0.79.

Exchange Control Operations

The Foreign Exchange Control (Amendment) Regulations 2000 assigns the authority over sending money and securities out of the Kingdom to the Reserve Bank. This authority includes licensing of foreign exchange dealers. The Reserve Bank has licensed two authorized restricted foreign exchange dealers under the Foreign Exchange Control (Amendment) Act 2000. These authorized foreign exchange dealers are the Fund Management Limited which operates Western Union and Rowena Financial Services Limited. Commercial banks are authorized dealers under their banking license.

The Reserve Bank is liaising with the Ministry of Labour Commerce and Industries to set up a framework to license all companies and businesses that are currently accepting foreign exchange and making foreign exchange payments and transfers. Any entity that is engaged in buying and selling foreign exchange must be licensed by the Reserve Bank under the Foreign Exchange Control Act.

The Foreign Exchange Control (Amendment) Regulations 2000 gives the Reserve Bank the administrative powers of the Foreign Exchange Control Regulations. The Reserve Bank's prior approval is required for all outward current transfers of T$50,000 and above and all capital transfers irrespective of the amount. All outward current transfers of less than T$50,000 have been delegated to the commercial banks and licensed foreign exchange dealers. The requirements were introduced in 2000 to assist the Reserve Bank with the management of the official foreign reserves, when it fell below the adequate level.

During 2005/06, the Reserve Bank strengthened its exchange control policies and issued four Exchange Control Directives to the commercial banks and authorised foreign exchange dealers. After consultation with the banks and the Commissioners of Revenue, the Reserve Bank issued exchange control documentary requirement guidelines to the banks and authorized foreign exchange dealers. These guidelines require the banks and authorized foreign exchange dealers to sight supporting documents prior to sending foreign exchange outward payments. These changes were introduced by the Reserve Bank to provide a level playing field in the foreign exchange market, improve the consistency of the exchange control process in the financial system, improve the accuracy of balance of payments statistics and assist with the protection of the country's foreign reserves. The documentary requirements guidelines would also assist the banks and authorized foreign exchange dealers in complying with the requirements in the Money Laundering & Proceeds of Crime Act 2000 and would minimise the risk of loss of credibility and investor confidence in the Tonga's financial system.

The Reserve Bank processed 649 exchange control applications amounting to T$140.3 million (of which 8 percent were classified as capital transactions) compared to 607 exchange control applications processed in 2004/05 amounting to T$128.8 million. The increase in exchange control applications may be attributed to the strengthening of the exchange controls by the Reserve Bank and the increase in awareness by the banks and the authorised foreign exchange dealers on the exchange control requirements in Tonga.

Registrar of Government Bonds

The Reserve Bank acts as registrar for all of the Government of Tonga's bond issues, the total value of which was $24.9 million at 30 June 2006 compared to $25.4 million in the previous year. The total value of government bonds declined towards the end of the year because the Reserve Bank did not underwrite the rollover of the two government bond issues which matured during the financial year. The Reserve Bank also seeks to develop the domestic capital market in Tonga and is marketing its holdings of government bonds on its website and in press releases. The Reserve Bank may also provide a secondary market for government bonds to increase or reduce liquidity in the banking system depending on the Reserve Banks monetary policy stance. During November 2005, the Reserve Bank, at the request of the banks, purchased government bonds before maturity to provide liquidity support to the banking system.

Export Finance Liquidity Facility

The Reserve Bank established the export finance liquidity facility in 1990 to ensure that any liquidity constraints in the banking system would not impede the financing of merchandise exports. There were no advances under the export finance liquidity facility during the year.

Financial Institutions

The National Reserve Bank of Tonga Act, 1988 and the Financial Institutions Act, 2004 authorise the Reserve Bank to undertake the prudential supervision of the licensed financial institutions. The primary objectives of the Reserve Bank in this area are the stability of the financial system and the security of depositors' funds with licensed financial institutions. The Financial Institution Act 2004, which replaced the 1991 Act, updated the requirements under the old Act in order to enable the licensing and supervision of financial institutions in Tonga to be in general conformity with internationally accepted standards embodied in the Basel Core Principles for Effective Banking Supervision, and modern banking practice. The new Act also strengthens the supervisory role of the Reserve Bank.

Issue of new banking license to the Managing Director, Tonga Development Bank

During the year, there was no change to the composition of the financial system in Tonga which is three commercial banks, a development bank and the central bank.

The Financial Institutions Act, 2004 became effective on 3rd October 2005 and on the 9th of November 2005, the financial institutions that were in operation were issued a banking license under this new Act.

Financial Sector: Facilities and Operations

Licensed Financial Institutions in Tonga

Financial Institutions	Headquarters
Westpac Bank of Tonga	Nuku'alofa, Tonga
MBf Bank Limited	Nuku'alofa, Tonga
Australia and New Zealand Banking Group Limited	Melbourne, Australia
Tonga Development Bank	Nuku'alofa, Tonga

The Westpac Bank of Tonga maintained its head office and two branches on Tongatapu as well as branches on the islands of Vava'u, Ha'apai, and 'Eua. The MBf Bank Limited maintained its head office on Tongatapu and a branch on the island of Vava'u. The ANZ Bank operated its main branch on Tongatapu and also maintained a sub-branch on Vava'u. The TDB maintained its head office on Tongatapu, as well as branches on the islands of Vava'u, Ha'apai, 'Eua, Niuatoputapu and Niuafo'ou.

The total assets of the financial sector (licensed financial institutions) reached $361.3 million in 2005/06, an increase of $40.9 million (12.8 percent) over the year. This was contributed mainly by an increase of $49 million (21.8 percent) in total net loans by the banks to the non-financial sector compared with a $46.4 million (25.9 percent) growth recorded in 2004/05. At the end of the 2005/06, the banks' outstanding loans portfolio comprised:

56.2 percent for private individuals (of which 39.7 percent was for housing); 41.3 percent for industries and businesses including agriculture; and the remaining 2.5 percent was for other types of loans. The unsustainably strong growth in credit extended by banks to the private sector brought about a very tight liquidity position to the banking industry. This forced some banks to redeem their investments in government securities before maturity. At the end of June 2006, the redemption of investments in government bonds of $7.1 million was partly offset by new investments in NRBT notes of $1.5 million.

On the liabilities side, total deposits by non-financial sector grew by $32.8 million (16.5 percent) to $231.5 million in 2005/06 while the total number of accounts reported to have decreased by 51.2 percent to 44,557 (Table 4). A large amount of the increase in the value of savings deposits was due to the payment of redundancy packages at the end of June 2006. The significant decline in the number of accounts is largely attributed to the automation of the capturing of the number of accounts resulting in the clean up of several small accounts by the banks during the year. Total borrowing by the banks from other financial institutions increased by $6.1 million (11.2 percent) mainly sourced from overseas banks. Total notes and bonds issued by the banks decreased by $6.1 million (22.9 percent) over the year.

Table 4. FINANCIAL SECTOR ACCOUNTS

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
Demand Deposits						
Number of Accounts	3,035	6,711	17,751	14,487	22,077	2,878
Value of Deposits ($m)	40.4	46.5	57.4	69.7	68.3	56.1
Saving Deposits						
Number of Accounts	73,502	56,978	53,790	29,693	66,885	39,361
Value of Deposits ($m)	31.2	36.8	36.9	37.1	41.9	62.4
Time Deposits						
Number of Accounts	3,413	4,505	5,546	2,002	2,428	2,318
Value of Deposits ($m)	48.5	49.5	49.3	67.2	88.4	113.0
Total Number of Accounts	**79,950**	**68,194**	**77,087**	**46,182**	**91,390**	**44,557**
Total Value of Deposits ($m)	**120.2**	**132.8**	**143.5**	**174.0**	**198.6**	**231.5**

Source: Licensed Financial Institutions.

Financial Performance

The total financial sector as a group showed a pre-tax profit of 5.3 percent in 2005/06, compared with 6.1 percent in 2004/05. This was due to an increase in the banks' average assets while profitability remained relatively unchanged over the year (Table 5).

Total operating income was 11.5 percent of average assets, a decrease from 12.6 percent in 2004/05. Net interest income was 6.9 percent of average assets. Even-though the bulk of banks' operating income was derived from the extension of loans, the composition of net interest income fell to 59.5 percent of total operating income in 2005/06 compared with 60.7 percent in 2004/05. Foreign exchange business made up 23.4 percent of total operating income, a slight increase from 23.0 percent in the previous year and the balance of 17.1 percent came from commission and charges plus other income sources. Total non-interest income,

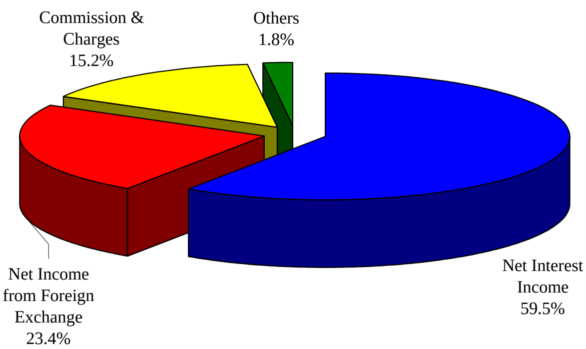
Table 5. FINANCIAL PERFORMANCE

	2001/02	2002/03	2003/04	2004/05	2005/06
Pre-tax Net Profit (% average total assets)	7	5.5	5.2	6.1	5.3
Total Operating Income (% average total assets)	11.9	11.5	12	12.6	11.5
Net Interest Income (% average total assets)	7	7.4	7.4	7.7	6.9
Non-interest Income (% average total assets)	4.9	4.1	4.6	4.9	4.7
Average Net Interest Margin (%)	8.4	8.9	8.9	9.8	8.3
Total Operating Expenses (% average total assets)	5.1	5	5.6	5.7	4.9
Consolidated Risk-weighted Capital Ratio (%)	25.2	21.8	27.6	22.4	21.2

Source: Licensed Financial Institutions.

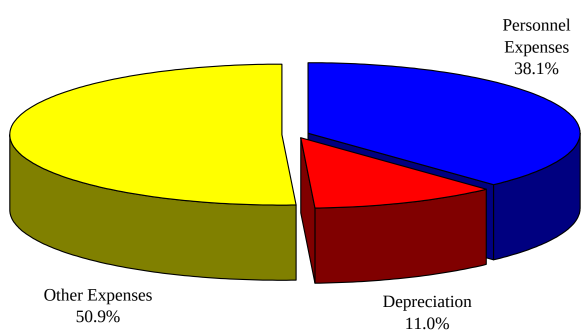
as a percentage of average assets slightly fell to 4.7 percent from 4.9 percent in the previous year. The average net interest margin (net interest income as a percentage of average earning assets) for the banks decreased to 8.3 percent in 2005/06 compared with 9.8 percent in 2004/05. The decline in the net interest margin was largely attributed to the increase in interest expense when banks increased deposit interest rates as the competition for deposits intensified.

Figure 8 : Financial Sector - Components of Operating Income



Source: National Reserve Bank of Tonga

Figure 9 : Financial Sector - Components of Total Operating



Source: National Reserve Bank of Tonga

The operating expenses of the banks decreased to 4.9 percent of average assets in 2005/06 compared to 5.7 percent in 2004/05. This was due mainly to an increase in the banks' average assets over the year. About 38.1 percent of administrative expenses of the banks were taken up by employees' remuneration, an increase from 36.1 percent in the previous year. Depreciation and amortisation accounted for 11.0 percent of total administrative expenses and the balance of 50.9 percent was made up of the purchase of various goods and services necessary for the operations of the banks.

Liquidity

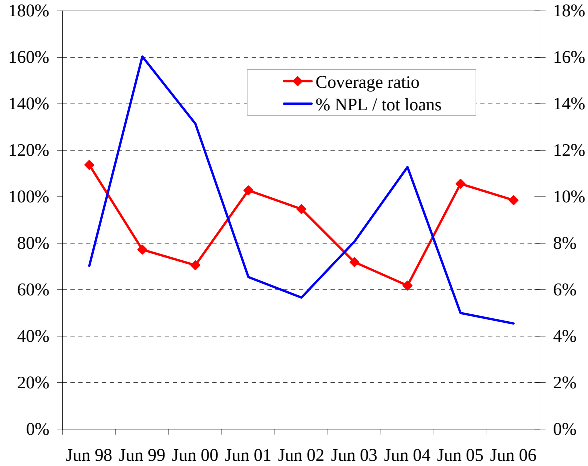
Liquidity in the banking system had weakened in 2005/06, despite the increase in savings and time deposits.

Net loans as a proportion of deposits rose to 98.2 percent from 90.6 percent in 2004/05. This was underpinned by the significant expansion in credit over the year. The tight liquidity situation prompted a deposit campaign by the banks to attract deposits by increasing of deposit interest rates. The Reserve Bank facilitated early redemption of banks' investment in government bonds to provide liquidity support to the banking system.

Capital

Even-though the consolidated risk weighted capital ratio for all the banks decreased slightly to 21.2 percent at the end of 2006 compared with 22.4 percent at the end of June 2005, the capital position of the banking industry remains strong and above the minimum ratio required by the Reserve Bank. The decline in the capital adequacy ratio over the year was attributed mainly to the growth in risk-weighted assets reflecting the strong lending by the banks during the year.

Figure 10: Financial Sector - Non Performing Loans - Coverage Ratio



Source: National Reserve Bank of Tonga

Asset Quality

The overall quality of the banks' assets slightly improved over the year. Total non-performing loans declined to 4.5 percent of total loans compared with 5.0 percent at the end of June 2005. The slight decline in the coverage ratio of the non-performing loans by total loan loss reserves reflected the growth in total non-performing loans outweighing the growth in total provisions over the year (Figure 10).

Supervision of Licensed Financial Institutions

During the year, the Financial Institutions Department, which is responsible for the supervisory functions of the Reserve Bank, continued its supervisory activities. The Reserve Bank continued to monitor and evaluate the overall strategies, policies and performance of licensed financial institutions, where appropriate with reference to specific legal and/or prudential criteria, and formed a view as to the soundness of the risk management systems of financial institutions and the competence of those managing them. The Reserve Bank continued to administer its activities through offsite and onsite surveillance. Reports from licensed financial institutions were analysed to ensure that their activities complied with the terms and conditions of their licences and other specified regulatory and prudential standards such as capital adequacy, limits on credit exposures, asset quality, credit risk grading and provisioning. The reports were also analysed for any significant changes in their financial conditions.

During the year a draft Prudential Statement on Administrative Penalties and Anti-Money Laundering Guidelines were issued to the banks for comments. These requirements became effective in October 2006.

The Reserve Bank conducted an on-site examination on one licensed financial institution to review its risk management systems and their applications. The main focus of the risk management review was mainly on credit, operational, liquidity, interest rate and foreign exchange risk management systems as well as compliance with anti-money laundering and combating the financing of terrorism laws. The Reserve Bank also conducted its first on-site examination of one of the licensed foreign exchange dealers in August 2005. This review focused on compliance with the terms and conditions of its licence and compliance with the Reserve Bank’s anti-money laundering and exchange control requirements. The Reserve Bank also continued to hold regular meetings with licensed financial institutions in order to discuss their operations and compliance with the financial institutions regulations. In addition, the Reserve Bank conducted quarterly technical meetings with each bank to clarify the Reserve Bank’s reporting requirements, improve the accuracy of reporting to the Reserve Bank and to discuss any issues of mutual interest to both parties.

Transaction Reporting Authority

The Financial Institutions department is also responsible for carrying out the functions of the Transaction Reporting Authority (TRA) as stipulated under section 11(2) of the Money Laundering and Proceeds of Crime Act 2000. The functions of the TRA are similar to the functions of Financial Intelligence Units (FIU) in other countries.

During the year, the Reserve Bank continued with its effort to develop its suspicious transaction reporting framework in cooperation with licensed financial institutions. The commercial banks reported a total of 5 suspicious transactions to the TRA during the year. The small number of suspicious transaction reported so far could be attributed to the lack of awareness regarding money laundering and terrorist financing.

In May 2005, the Australian Transaction Reports and Analysis Centre (AUSTRAC) conducted an IT needs assessment under the Pacific FIUs Database Project (PFIUDP) through the AusAID Program. This assessment resulted in the installation of a software in October 2005 at the TRA unit to compile and analyse suspicious transaction reports.

Tonga was formally admitted as the 29th member of the Asia Pacific Group on Money Laundering (APG) at its Annual Meeting in Cairns, Australia in July 2005. Tonga through this membership would be able to acquire support and assistance from this Regional Organization and other donors in developing its legal, financial, regulatory and law enforcement framework to meet international anti-money laundering and counter terrorism financing standards.

In January 2006, the Reserve Bank in collaboration with ANZ Bank conducted a half day presentation on ANZ’s anti-money laundering framework. This was a first opportunity for some of the stakeholders in Tonga’s anti-money laundering regime to meet face-to-face.

Participants were from the licenced financial institutions authorised restricted foreign exchange dealers and other relevant government agencies.

Through Tonga's membership in the APG, the TRA held its first Industry AML/CFT Awareness Workshop in May 2006 with the assistance from the Australian Attorney General's Anti-Money Laundering Assistance Team (AMLAT). The participants found this 2-days awareness workshop very informative and relevant to their areas of work. Participants at this workshop included Representatives from the Crown Law Department, Police, Customs, Inland Revenue, Immigration, Ministry of Finance, Ministry of Labour Commerce and Industries, Licensed Financial Institutions and Licensed Restricted Foreign Exchange Dealers.

The Committee on Money Laundering and Terrorist Financing established by Cabinet in 2003 of which the TRA is a member, met in May 2006 and established a technical sub-committee to advise the main Committee on issues relating to Money Laundering and Terrorist Financing. This sub-committee is to be the operational arm of the main Committee that seeks to coordinate all stakeholders' efforts to work towards ensuring compliance with international standards related to anti-money laundering and terrorist financing and compliance with the terms and conditions of Tonga's membership in the APG.

Participants in the NRBT Anti-Money Laundering Workshop, held at the Free Weslyan Church Moulton Conference Hall

Operations of the Reserve Bank

Currency Operation

Circulation Notes

At the 30th June 2006, the face value of currency notes on issue, both new and reissuable, totalled $19.5 million. This was an increase of 15 percent over the previous year. Currency notes issued during the year totalled $44.2 million and currency deposited totalled $41.6 million of which $3.3 million were classified by the Reserve Bank as unfit for reissue and were destroyed; the balance was retained for reissue. In order for the Bank to maintain an adequate supply of currency notes to meet public demand, the Bank ordered and received new stock of $1, $2, $5 and $10 currency notes during the year. The currency notes of the Kingdom are printed by De La Rue in the United Kingdom.

Circulation Coins

At the end of June 2006 the face value of coins on issue totalled $1.6 million. During the year, coins to a face value of $184,704 were issued, $63,425 of which were new coins. During the year the Bank ordered and received new 1c, 5c and 10c coins from the Royal Mint of the United Kingdom.

Note Trust Depots

The Reserve Bank has Note Trust Depot (NTD) agreements with all commercial banks. The record shows that commercial banks increased its utilisation of NTDs this year. During 2005/06 the commercial banks lodged a total of $18.5 million ($11.1 million in 2004/05) and withdrew $19.1 million ($11.3 million in 2004/05). Lodgements to and withdrawals from NTD's increased by 67 and 69 percent respectively over the previous year while deposits to the NRBT vault decreased by 28 percent.

Counterfeits

During the year, 7 pieces of counterfeit $10 notes were reported to the Reserve Bank. These counterfeit notes were reported from the commercial bank's branches in Vava'u during September and October 2005. The Reserve Bank sent these counterfeit notes to De La Rue for testing and verification. Examination of these notes by De La Rue confirmed that they were indeed counterfeit. The Reserve Bank has produced and issued to the public brochures on identifying counterfeit notes both in English and Tongan. The public has also been advised to report to both the Reserve Bank and the Police if they receive any suspicious looking currency notes.

Numismatic Coins: Circulation Coins

Numismatic Coins

During the year numismatic coins were issued to collectors throughout the world under agreements between the Reserve Bank and various producers for the production and marketing of coins of various denominations. Total revenues collected from numismatic coins program during the year was $82,395 and this amount has been included with other income of the Reserve Bank in its Income Statement.

Financial Performance

Gross income from operations for the year ended 30 June 2006 amounted to $6.236 million (2005, $5.473 million). Interest expense, currency, administration and other costs totalled $3.079 million (2005, $3.179 million). The net operating profit for the year was $3.156 million (2005, $2.294 million).

The 37% increase in net operating profit was due to higher interest income received from the investment of the external reserves and a reduction in currency expenses. In previous years the cost of notes and coins were amortised over a three year period, however, as from this year the currency expense is based on the cost of notes and coins issued for circulation. The improvement in the Reserve Bank's gross income in 2005/06 was mainly due to higher than expected level of investible reserves and yield throughout the year.

The Minister of Finance has approved that the net profit of $3.156 million for the year ended June 2006 be transferred to the Reserve Bank's General Reserve account. This would strengthen the capital position of the Reserve Bank.

The Reserve Bank in preparing its 2005/2006 annual set of accounts has adopted and complied with the requirements of the International Financial Reporting Standards (IFRS) with the exception of the treatment of foreign currency gains and losses, where it will continue to comply with the provisions of the National Reserve Bank of Tonga Act.

Information Systems and Technology

During the year, the Information Systems and Technology Department continued to work towards providing an effective and efficient computer system to support the functions of the Bank. The security of the Bank's network infrastructure was improved with the installation of CISCO and ISA firewalls. The Microsoft Exchange Server 2003 email system was also implemented. The Bank's Website was improved for easier access to readers and a first draft of a Business Contingency Plan Guideline for the Bank was developed. The database systems used by accounts, settlements and administration were also improved during the year.

The IST Department continued to conduct in-house computer training programmes for the staff to enhance the effectiveness and efficiency of their work.

General Administration

During the year a set of revised Human Resource Management Policies approved by the Board were implemented. This included a generic review undertaken by Pricewaterhouse Coopers of the salary structure of the Bank in comparison to 5 major comparators in the market. This resulted in a salary increase to put the Bank's salary structure in line with the market range. Furthermore, a performance-based appraisal system was established to be implemented at the beginning of the 2006/2007 financial year. This is to replace the fixed salary system the Bank had been using and to encourage high performance by clearly defining job descriptions, identifying training needs, providing feed back and awarding salary increases to staff based on their level of performance. Other Human Resource Management Policies that were revised during the year included the Terms and Conditions of employment of the Bank, Staff Training Policies, the Rules and Orders of the Bank, and the Staff Group Insurance Schemes.

Staff

Staff numbers reached 65 at the end of June 2006, an increase of two from the previous year. One of the starting members of the staff of the Reserve Bank, Ms Kalolaine Katoa retired at the end of June 2006 after serving the Bank for 17 years.

During the year, the Reserve Bank continued to receive advisory and technical services provided by the International Monetary Fund, AusAID, NZAid, AUSTRAC, AMLAT, the Pacific Financial Technical Assistance Centre based in Suva, Reserve Bank of Fiji, Reserve Bank of New Zealand, Reserve Bank of Australia and the Bank of England's Centre for Central Banking Studies. These advisory and technical services were mainly in the areas of Banking Supervision, Anti-money Laundering, Interactive Planning and Leadership Management, Monetary Policy, Information Systems and Technology, Administration, and other central banking areas. Other assistances were received from private service providers on the areas of information systems and technology and accounts.

Training

During the year, the Reserve Bank continued to provide local and overseas training opportunities for its staff to facilitate capacity building. The Bank provided overseas training courses in specialized areas relevant to their function. The overseas training courses included the IMF/STI courses in Singapore on anti-money laundering and combating of terrorist financing, and Monetary and Financial Statistics, PFTAC/AFSPC workshop for the Association of Financial Supervisors Pacific Countries, AUSTRAC IT Pacific FIU Database Workshop, AMLAT Regional Workshop for Pacific Financial Intelligence Units, and the South Pacific Central Banking conference hosted by the Bank of England Centre for Central Banking Studies and the Reserve Bank of New Zealand. The Bank arranged for 3 senior staff to attend short training attachments at the Security Unit of the Reserve Bank of New Zealand, the Building Unit of the Reserve Bank of Fiji, and the Systems and Technology Department of the Reserve Bank of Australia. One of the IT staff

Heads of Units General Management and Leadership Training attended a Cisco Training course held in Fiji. Another staff member continued with her post graduate studies under the AusAID scholarship programme in Australia.

Local training for staff included the Microfinance Training workshop, Fire Fighting hosted by the Ministry of Police, the Anti-Money Laundering industry awareness workshop, Pacific Regional Terrorism, Transnational Crime & Border Security Seminar and the Tonfon Wireless Technology workshop. The Reserve Bank provided in-house training to the staff on the following areas: general management and leadership skills, banking supervision, information mailing system awareness, Microsoft applications training and on-site training for payroll and accounting package. The Reserve Bank continued to support staff development through financial assistance to those undertaking approved part time and correspondence courses aligned to the Training Policy of the Bank.

Attendance at Meetings

In July 2005, the Governor and the Assistant Manager Financial Institutions attended the APG Annual meeting held at Cairns, Australia. In September 2005, the Governor and the Acting Senior Research Officer were part of the government's delegation to the annual meeting of the World Bank/IMF held in Washington DC. In February 2006, the Deputy Governor attended the SEACEN Executive Committee Meeting held in Fiji. In March 2006, the Governor attended the PFTAC Review meeting held in Nadi, Fiji at the invitation of PFTAC. In April 2006, the Assistant Manager Administration and Information Technology attended the first STI/IMF Training meeting held in Singapore. In May 2006, the Governor attended the ADB annual meeting held in India as part of the Government's delegation and in June 2006, she attended the Bank of England Symposium and the Bank of International Settlement's annual meeting.

Security

The Bank's security unit continued to carry out its responsibilities of ensuring that the security and safety of the bank's staff and premises are maintained at all times. It contributed to the secured delivery of currency shipments to the Bank. The security system of the Bank was enhanced by moving out the security check point to the fence.

Building, Plants and Equipment

The Bank's building, plants and equipment unit continued to maintain the Bank's building, plant and equipment at a high standard. The major projects completed this year included the upgrading of the Reserve Bank's electricity standby generator and its contribution to the completion of the revisions to the Bank's emergency evacuation booklet. This unit is arranging repair work to the minor damages to the building caused by the earthquake that hit Tonga on the 4th of May 2006.

External Relations

In March 2006, the Reserve Bank coordinated the annual IMF article IV mission. During the year, the Reserve Bank continued to prepare reports for the government on the level of the foreign reserves, interest rates and exchange rates. The Reserve Bank conducted regular meetings with the domestic banks in order to review activities in the banking sector as well as to discuss policy issues. The Reserve Bank also met with representatives of international aid agencies and bilateral aid donors to discuss matters of mutual interest. In July 2005, the Reserve Bank welcomed a visit from the Parliamentarians and conducted a presentation on the functions of the Bank, and on the monetary and economic conditions of the country.

Board of Directors

During the year the Board of Directors met regularly to formulate the policies of the Reserve Bank and to monitor its operations. The resignation of HRH Prince ‘Ulukalala Lavaka Ata in February 2006 vacated the position of the Chairman of the Board.

Senior Officers

Senior Officers as at 30 June 2006

Governor	Siosi Cocker Mafi
Deputy Governor	Inia R. Naiyaga
Manager, Financial Institutions & Markets	Jessie Cocker
Manager, Research Department	Brett Winton
Assistant Manager Information System & Technology and Administration	Elizabeth Baker
Assistant Manager, Accounts & Currency	Lata Tangimana
Assistant Manager, Financial Institutions	‘Ungatea Latu
Senior Research Officer	‘Anapuli Matoto
Guard Commander	Semisi Fifita
Senior Building Officer	Poasi Fonua