NATIONAL RESERVE BANK OF TONGA

Monetary Policy Statement

February 2017

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List of abbreviations

AML/CFT	Anti-Money Laundering/Counter Terrorist Financing
AUD	Australian Dollar
EXIM	Export-Import
EU	European Union
FEDs	Foreign Exchange Dealers
GDP	Gross Domestic Product
HTFA	High Temperature Forced Air
IMF	International Monetary Fund
JPY	Japanese Yen
LDS	Latter Day Saints
MAFF	Ministry of Agriculture, Food & Forests
MPS	Monetary Policy Statement
MSMEs	Micro Small and Medium Enterprises
NBFIs	Non-Bank Financial Institutions
NEER	Nominal Effective Exchange Rate
NRBT	National Reserve Bank of Tonga
NZ	New Zealand
NZD	New Zealand Dollar
OET	Overseas Exchange Transactions
OPEC	Organization of the Petroleum Exporting Countries
PACER	Pacific Agreement on Closer Economic Relations
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
SMEs	Small to Medium Enterprises
TDB	Tonga Development Bank
TOP	Tongan Pa'anga
UK	United Kingdom
US	United States
USD	United States Dollar
WEO	World Economic Outlook

Overview

Recent Development

The Reserve Bank maintained its current monetary policy stance. This supported the monetary policy objectives of maintaining internal and external monetary stability, promoting financial stability and a sound and efficient financial system and conducting its activities in a manner that supports macroeconomic stability and economic growth. This was by ensuring adequate level of foreign reserves was maintained above 3 – 4 months of import cover, despite annual headline inflation rising to a very high level in February 2017 which was above the reference rate of 5% annually. This reflected the new custom duties and excise taxes introduced in July 2016, rise in global oil and food prices, seasonality in local produce, and shortage of kava-Tonga supply.

The Statistics Department has released its official estimates of real GDP for 2014/15 and its preliminary estimates for 2015/16, indicating a stronger growth. The Reserve Bank's outlook for a robust domestic economic growth remains for 2016/17 and over the next two financial years 2017/18 to 2018/19. This is expected to be driven by strong growths in financial intermediation, construction, trade and tourism.

In 2016/17, the Reserve Bank estimated a stronger real GDP growth of 3.7% coinciding with a 3.6% growth projected by the IMF Staff Visit in March 2017. This is an upward revision from the estimated 3.6% growth released in the August 2016 MPS, and is mainly driven by anticipated stronger growths in the construction sector and spillover effects on the utilities and the mining & quarry sectors, as well as robust growth in the fisheries sector. Moreover, the number of celebrations and events scheduled for 2016/17 is expected to support the growth in tourism and trade sectors. This includes the LDS Tonga Mission Centennial celebration, school anniversaries particularly for Chanel College Kelana, Tailulu College (Tongatapu) and Mailefihi Siu'ilikutapu College and annual church conferences.

Inflationary pressures continued to rise in February 2017. The annual headline inflation rate increased significantly by 8.9% in February 2017 compared to a 5.1% rise in August 2016, and remained above the Reserve Bank's reference rate of 5% per annum.

The overall balance of Overseas Exchange Transactions (OET) over the past six months to February 2017 was a surplus of $11.4 million. This was three times lower than the surplus recorded for the past six months to August 2016 of $37.7 million.

The overall surplus in the OET contributed to an increase in the gross official foreign reserves to $377.7 million in February 2017, compared to $366.3 million in August 2016. This was sufficient to cover imports of merchandise goods and services for 7.1 months[1], well above the Reserve Bank's minimum range of 3-4 months of imports. In year ended terms, gross official foreign reserves rose by $49.1 million. The lower deficit in the current account balance as a result of higher remittances, higher receipt of foreign aid from donor partners and budgetary support for the Government, contributed to the higher foreign reserves over the past year.

Over the 6 months to February 2017, the banking system remained sound with strong capital and liquidity position maintained, supported by comfortable profitability, and non-performing loans continuing to remain low. Total banks' lending recorded its highest level in February 2017 at $384.5 million, which increased by $29.3 million (8.2%) from August 2016. Both household and business loans contributed to this growth, supporting economic activities.

Excess liquidity in the banking system remains owing to higher foreign reserves during the six months to February 2017. Broad money continued to rise over the last six months to February 2017 by $19.2 million (3.9%) to $510.2 million. This resulted from a $24.3 million (6.4%) increase in net foreign assets offsetting a $5.1 million (4.5%) decline in net domestic assets. During the last six months, broad money reached a new record high of $512.2 million in December 2016. The banking system liquidity[2] (reserve money) increased over the last 6 months to February 2017 by $10.8 million (4.0%) to $278.0 million. Throughout the last 6 months, liquidity hit a new level high of $281.3 million in December 2016 which coincided with the new record of broad money stated for the same month. Higher deposits over the past 6 months further supported the growth in reserve money. Total loan to deposit ratios slightly fell in February 2017 to 73.3% from 73.7% in August 2016. This remained below the

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

[2] Liquidity (reserve money) in the banking system is a sum of currency in circulation, exchange settlement account balances, and required reserve deposits.

80% minimum loan to deposit ratio target which indicated excess liquidity in the banking system remains. Despite the strong growth in the banks' loan books, this was outweighed by the continuous growth in deposits, which coincided with the higher foreign reserves. This indicates more capacity remains for further lending by the banks, however, the Reserve Bank will continue to closely monitor the lending growth to avoid any overheating in the economy.

Banking system data shows the net credit to Government declined by $28.6 million (43.2%) over the six months to February 2017, driven by rising Government deposits during the period.

Outlook

The Reserve Bank anticipates a strong real GDP growth of 4.8% in 2017/18, an upward revision from the August 2016 MPS estimate of 4.7% and slightly higher than the 4.1% growth estimated by the IMF Staff Visit 2017. This growth is expected to be driven by construction, as Government continues the construction of sports facilities. Additionally, growth in the financial intermediation, transport & communication, trade, fishing and tourism sectors are also expected to contribute to the anticipated overall economic growth.

The Reserve Bank expects the upward inflationary pressure to remain in the near term due to the impact of the increased custom duty and excise tax effective in July 2016. However, the annual headline inflation is forecasted to gradually decline below the reference rate of 5% per annum after August 2017. The uncertainty in movements in global food and oil prices may pose a risk to this outlook. Additionally, the vulnerability of Tonga to natural disasters and adverse weather conditions also 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 supported by expected higher receipts of remittances, higher export receipts, anticipated government receipt of budget support and grant funds from development partners and this will be partially offset by the projected rise in import payments. The Reserve Bank forecast the level of foreign reserve to increase to $385.4 million in June 2018, which is higher than the IMF Article IV projections of $367.0 million.

The Reserve Bank's credit growth forecast for 2016/17 still stands at 15% as published in the August 2016 Monetary Policy Statements (MPS). This is higher than the projection by the IMF Article IV of 10.8% for 2016/17. Credit growth is projected to continue to grow in the next six months. The Reserve Bank's policy measure imposing a requirement on banks' loans/deposit ratios effective 1st July 2016 should encourage further lending and support the continued growth in credit and broad money. In addition, the Reserve Bank's initiative to encourage lending to Micro, Small and Medium Enterprises is also expected to contribute to credit growth. At the same time, structural reforms in various sectors as well as other impediments to lending such as the improvement to the land administrative system and a bankruptcy laws would improve the confidence of the banks to lend further in a prudent manner.

Net credit to the Government is anticipated to decline, as a result of expected Government budgetary support and grants receipts.

In light of the above developments and the outlook on the monetary policy, the Reserve Bank will closely monitor the monetary conditions to avoid any overheating in the economy.

Sione Ngongo Kioa
Governor

1. Global Developments

World Growth

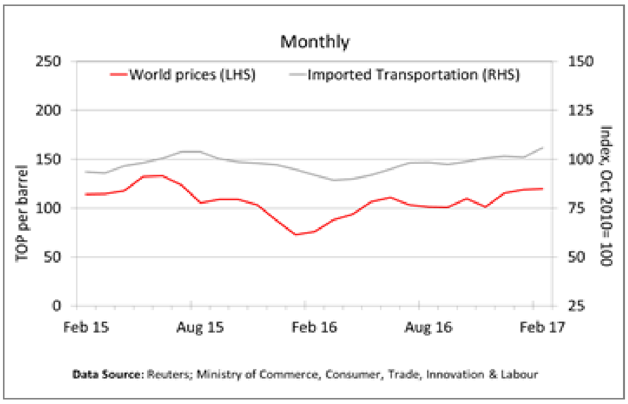
Global growth is expected to improve in 2017 and 2018 than previously anticipated in the IMF World Economic Outlook (WEO) in October 2016. The latest IMF WEO released in April 2017 has now projected a brighter outlook with upward revisions for global growth. More specifically, growth is expected to rise by 3.5% in 2017, an upward revision from 3.4% in the October 2016 WEO, and up from 3.1% in 2016 and is expected to remain steady at 3.6% in 2018. These revisions resulted from strong economic growth in a number of emerging market and developing economies paired with advanced economies who continued to gain growth momentum. This further reflects an uptick in confidence and other potential monetary policy easing for advanced economies which include the United States (US), Europe and Japan. Commodity exporters who recently have been experiencing macroeconomic strains now expect some recovery in commodity prices thus possible improvements for growth lies ahead.

Recovery in commodity prices have helped lift global headline inflation and reduce deflationary pressures. However, core inflation remains subdued particularly in advanced economies. Whilst strong labour participation has been recorded amongst many emerging, developing as well as advanced economies, unemployment still remains above pre-crisis levels. The IMF WEO in April 2017 has indicated that the advanced economies have maintained accommodative monetary policy stance except for the US and UK. This stemmed from rising demand and inflationary pressures.

World Oil Prices

According to Reuters, world oil prices averaged around US$55.99 per barrel in February 2017. This is a significant increase since August 2016 where prices averaged around US$46.94 per barrel. This is also higher than an average of US$33.52 per barrel in the same month a year ago. The increasing world oil price was driven by a reduction in supply production. This was formalized by the announcement of the production agreement by the Organization of the Petroleum Exporting Countries (OPEC) in November 2016.

Figure 1: World Oil Prices



The IMF April 2017 WEO stated that oil prices are expected to rise to an average price of US$55 per barrel in 2017-18, compared with an average of US$43 per barrel in 2016. This is due to further expectations of supply cuts in oil production and commitments by influential oil exporting countries such as Saudi Arabia to cut production beyond its initial indication in the OPEC agreement.

Advanced Economies

The US recorded a pickup in growth due mainly to strong sales by businesses reflected also by stronger consumer spending. The Bureau of Economic Analysis released real GDP growth rate (annual) of 1.4% in the first quarter of 2017. Consequently, there is an upward revision of economic growth for 2017 and 2018 since the IMF October 2016 WEO. The IMF April 2017 WEO now projects growth for 2017 to be 2.3% (up from 2.2%) and for 2018 to be 2.5% (up from 2.1%). Since the US election, expectations of looser fiscal policy in the US have contributed to a stronger dollar and higher interest rates. Going forward, expectations of the US adopting its fiscal stimulus as widely discussed and deregulation changes could affect its GDP through fiscal deficit.

In terms of inflation, the US recorded 2.4% (over the year to March 2017) driven by a relatively strong recovery in energy prices. More specifically, prices are projected to pick up from 1.3% in 2016 to 2.7% in 2017. However, core inflation is expected to remain relatively subdued and to rise more gradually. Core inflation is projected to reach the 2% personal consumption expenditure inflation rate targeted by the Federal Reserve by 2018 as they expect economic slack to lessen and wage growth to strengthen.

The Reserve Bank of Australia (RBA) reported in its February 2017 MPS that growth in the Australian economy has slowed recording GDP growth of 2.0% at the end of 2016, which is below the economy's potential growth rate. This was a result of subdued consumption growth reflected by a relatively weak growth in household income. This is despite modest growth over the past two quarters and since the last August 2016 MPS release. On the outlook, the RBA projects GDP growth of around 2.5 – 3.5% over 2017 and 2.75% – 3.75% over 2018. This forecast is supported by low interest rates and rising resource exports particularly liquefied natural gas exports. The unemployment rate increased slightly towards the end of 2016 to 5.8% which is around its level a year earlier. Low wage growth may have partially affected capacity for absorption in the labour market. Liaisons conducted by the RBA paired with surveys by firms have indicated that the wage growth is unlikely to ease further. Headline inflation was recorded to be 1.5% (over the year to December 2016) and is expected to increase to around 2% in early 2017 and to be about 1.5% – 2.5% for the remainder of 2017 through to the end of 2018. This reflects rising oil and tobacco prices. Since the start of 2017, the Australian Dollar (AUD) has appreciated by more than 10% against the US Dollar (USD) alongside a significant increase in commodity prices. The RBA Board maintained its cash rate unchanged at 1.5% since August last year to support economic growth.

The Reserve Bank of New Zealand (RBNZ) stated in its February 2017 MPS that economic growth in New Zealand has increased as expected and is steadily drawing on spare resources. Annual GDP growth recorded in September 2016 was 3.5% driven mainly by business services and the construction sector and is expected to have an average growth of 3.6% over the next two years. Headline inflation increased by 1.3% in the December 2016 quarter due to higher oil prices. However, core inflation remained subdued. Longer term inflation expectations remain well anchored at around 2% which is within the RBNZ's target range of 1-3% driven by domestic prices and expectations for commodity prices to stabilize over time. Dairy prices have recovered in recent months but uncertainty still remains for future outcomes. Employment growth is expected to remain strong with the unemployment rate gradually declining to 4.5% from 5.2% as reported in the August 2016 MPS. The outlook remains positive supported by ongoing accommodative monetary policy, strong population growth, rising household spending and increasing construction activity. The RBNZ left its official cash rate unchanged at 1.75% to support economic growth.

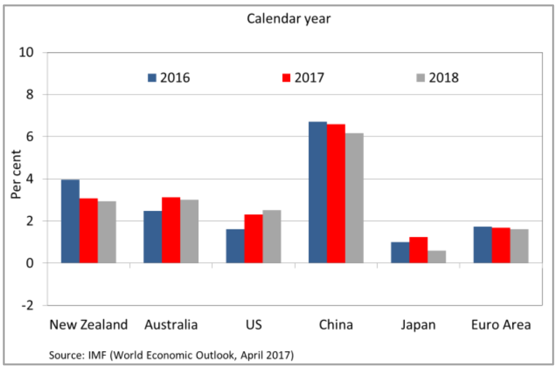
The IMF's April 2017 WEO reported solid growth for the United Kingdom (UK). This was reported to be 2.0% as at the end of the March quarter 2017. This follows previous downward revised projections as a result of Brexit in the last MPS. However, stronger-than-expected developments occurred over the last half year which resulted in fairly high growth for the UK driven by improved business and consumer confidences. Additionally, the pound's depreciation since Brexit and over the last six months actually helped exporters and further boosting tourism activities. However, the outlook still remains on the downside particularly for 2018 and beyond as political uncertainty regarding the European Union and the UK's future relationship is expected to weigh on economic activity. Consequently, the IMF in its April 2017 WEO upgraded GDP projections for the UK in 2017 to grow at 2% (from previously forecasted 1.1%) but expects in 2018 to slow down at 1.5% (down from 1.7%). As of the end of the March quarter 2017, inflation was 2.2%. The depreciation of the British Pound and the increase in energy prices are anticipated to push inflation up to 2.5% in 2017, before it falls to the Bank of England's target of 2% in the next few years.

The Euro Area is expected to continue its modest recovery over 2017 and 2018 following implications and effects of the referendum in mid-2016. The Euro Area recorded GDP growth of 1.9% in the first quarter of 2017. Therefore, the IMF's April 2017 WEO forecasts growth in 2017 revised to be 1.7% (up from

1.5%) and for growth in 2018 to remain unchanged at 1.6% in comparison to the IMF's October 2016 WEO. These projections are to be supported by a mildly expansionary fiscal stance, accommodative financial conditions, a weaker euro, and beneficial spillovers from a likely U.S. fiscal stimulus. The medium-term outlook for the whole Euro Area however remains dim, as potential growth is expected to be restricted due to weak productivity, adverse demographics, and for some countries, unresolved legacy problems of public and private debt overhang driven by high non-performing loans. Inflation is also expected to pick up to about 1.7% in 2017 from 0.2% last year driven by energy and food prices. Currently, inflation is recorded to be 1.8% as at the end of the first quarter of 2017. This is expected to gradually approach the European Central Bank's (ECB) inflation target of 2% over the next few years.

China's growth remained strong reflecting GDP growth of 6.9% in the first quarter of 2017. This was driven by continued policy support. The IMF April 2017 WEO reported that growth in China is projected at 6.6% for 2017 (up from 6.2%) and then slowing to 6.2% (up from 6.0%) in 2018. These upward revisions resulted from a policy support in the form of strong credit growth and reliance on public investment to achieve growth targets. Prices rose over the year to April 2017 by 1.2%. Inflation in China is expected to pick up to 2.4% in 2017 and to 3% over the medium-term driven by prices in the industrial sector.

Figure 2: Growth Projection in the Advanced Economies



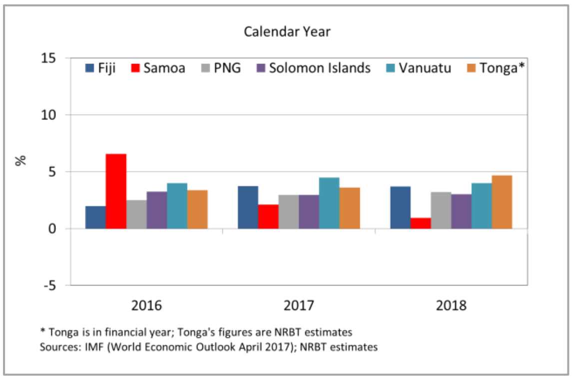
Japan recorded GDP growth of 1.3% at the end of the March quarter 2017 after undergoing a comprehensive revision of their national accounts. This also led to an upward revision of its historical growth rates and placed 2016 growth estimate at 1%.

The growth momentum is expected to continue in 2017 with a growth forecast of 1.2% (up from 0.6%) and 0.6% (up from 0.5%) in 2018 as reported in the IMF April 2017 WEO. The pace of expansion is expected to slow down following 2018 with the assumed withdrawal of fiscal support and a recovery of imports to offset the impact of stronger anticipated foreign demand and the Tokyo Olympics. Higher energy prices and the recent weakening of the Yen are expected to lift inflation in Japan. Consumer prices rose by 0.3% over the year to March 2017. However, the gradual rise projected for inflation is still expected to remain subdued and below the Bank of Japan's target of 2% throughout the forecast horizon.

South Pacific Economies

The South Pacific region showed an average GDP growth of about 3.6% since the August 2016 MPS. Inflation across the region's economies averaged around 2% - 3% driven by the recovery in crude oil prices and the appreciating US dollar, which is the intervention currency. Economic growth is projected to remain relatively around the range of 1% - 4% with possible stronger than expected growth across the region whilst inflation is expected to continue rising. The Reserve Bank of Fiji noted in its March 2017 Monetary Policy Stance Press Release that Fiji's economy expects positive performances of their tourism, remittances, and construction sectors.

Figure 3: Growth Projections in the Pacific



The Central Bank of Samoa reported in its MPS for 2016/17 that the economy is expecting strong growth to be driven mainly by a vibrant primary sector particularly fishing. The Reserve Bank of Vanuatu stated in its September 2016 MPS expectations of further growth in commodity exports namely copra and coconuts. The Bank of Papua New Guinea estimated high economic growth as a result of increasing mining activities and improvements in international prices for some export commodities.

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

	Real GDP growth (%)			Inflation (%)			Unemployment* (%)		
	2016	2017f	2018f	2016	2017f	2018f	2016	2017f	2018f
World Growth	3.1	3.5	3.6						
Australia	2.5	3.1	3.0	1.3	2.0	2.4	5.7	5.2	5.1
China	6.7	6.6	6.2	2.0	2.4	2.3	4.0	4.0	4.0
Euro Area	1.7	1.7	1.6	0.2	1.7	1.5	10.0	9.4	9.1
Japan	1.0	1.2	0.6	-0.1	1.0	0.6	3.1	3.1	3.1
New Zealand	4.0	3.1	2.9	0.6	1.5	2.0	5.1	5.0	4.8
United States	1.6	2.3	2.5	1.3	2.7	2.4	4.9	4.7	4.6

Note: f – forecast

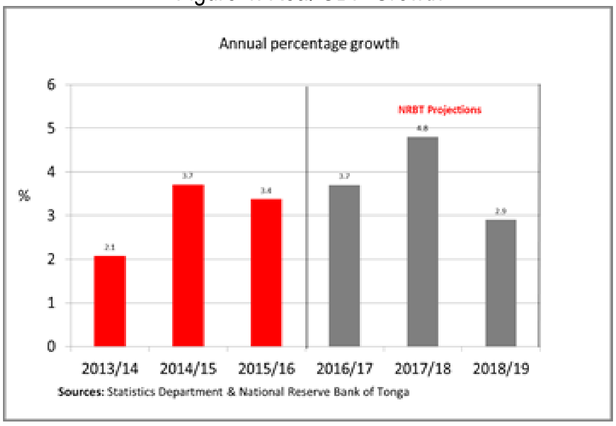
Source: IMF (World Economic Outlook, April 2017), NRBT

2. Tonga's Economic Growth

Real GDP Growth

Since the last MPS, the Statistics Department has released its official estimates of real GDP for 2014/15, indicating a stronger growth of 3.7%. Also, the provisional growth for 2015/16 is expected to have grown by 3.4%, similar to the Reserve Bank's projected growth. The fishing, construction, financial intermediation and, health and social work sectors were the major drivers of growth in 2015/16. Additionally, events that took place during the year boosted activities in the tourism and trade sectors.

Figure 4: Real GDP Growth



In 2016/17, the Reserve Bank estimated a stronger real GDP growth of 3.7%, an upward revision from the estimated 3.6% growth released in the August 2016 MPS. This coincides with a 3.6% growth projected by the IMF Staff Visit in March 2017. The upgrade in the growth outlook is mainly driven by anticipated stronger growths in construction, utilities, fisheries and mining & quarry. Moreover, the number of celebrations and events scheduled for 2016/17 supported the growth in tourism and trade sectors. This includes the LDS Tonga Mission Centennial celebration, school anniversaries particularly for Chanel College Kelana, Tailulu College (Tongatapu) and Mailefihi Siu'ilikutapu College and annual church conferences.

Higher real GDP growth of 4.8% is projected by the Reserve Bank for 2017/18, an upward revision from the August 2016 MPS estimate of 4.7% and slightly higher than the 4.1% growth estimated by the IMF Staff Visit 2017. This growth is expected to be driven by construction, as Government continues the construction of sports facilities. Additionally, the financial intermediation, transport & communication, trade, fishing and tourism sectors are also expected to contribute to the anticipated growth.

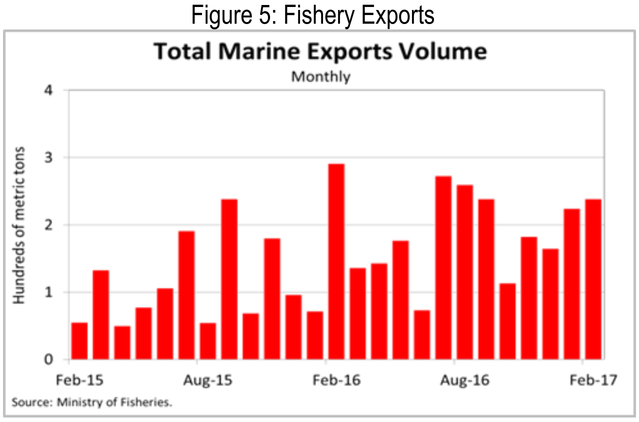
Looking forward, the Reserve Bank estimated the 2018/19 growth rate to slow to 2.9%. This is due mainly to the anticipated completion of major construction projects in 2017/18 such as the St. George Palace and Faua Wharf. However the financial intermediation, construction, transport & communication, and utilities sectors are expected to drive growth in 2018/19.

Primary Production

Growth in primary production for 2015/16 was largely driven by the Fishing sector which reported a 15.6% growth compared to a 7.4% in 2014/15. A slight upgrade to 5.4% in the growth for the fisheries sector is forecasted for 2016/17 compared to a 5.3% growth forecast in the August 2016 MPS.

This is supported by an increase in the marine exports, which rose by 502.3 metric tons (42.2%) in the first eight months of 2016/17. Exports of tuna increased the most by 478.6 metric tons (44.8%), followed by exports of snapper and shark meat by 28.1 metric tons (44.2%) and 25.2 metric tons respectively. This outweighed a decline in exports of seaweed by 29.7 metric tons (88.1). Banking system data for the same period indicated a $1.3 million (29.0%) rise in the fisheries export proceeds to $5.9 million. The Ministry of Fisheries, on the other hand, estimated the total value of the marine export proceeds to be $9.4 million in the first eight months of 2016/17. This implies that export proceeds of $3.5 million are being unaccounted for. Liaison with fishing exporters confirmed that the increase in the number of fishing vessels and favourable weather conditions during the reported period may have contributed to the overall rise in marine exports.

Figure 5: Fishery Exports



The outlook for the fisheries sector continues to remain positive, supported by the first Tonga Fisheries Sector Plan 2016/2024. In November 2016, the Ministry of Fisheries conducted a workshop on the

Table 2: Real GDP Growth Forecast

	Official 2013/14	Official 2014/15	Preliminary 2015/16	FY 2016/17 (Aug-16 MPS) %	FY 2016/17 (Revised) %	FY 2017/18 (Aug-16 MPS) %	FY 2017/18 (Revised) %	FY 2018/19 (Forecast) %
GDP	2.0	3.7	3.4	3.6	3.7	4.7	4.8	2.9
Primary production	**3.1**	**-2.7**	**2.1**	**2.9**	**2.9**	**2.5**	**2.6**	**2.1**
Agriculture	4.7	-4.8	0.3	2.5	2.5	2.0	2.0	1.8
Forestry	4.3	16.8	-20.2	0.1	0.1	0.2	0.1	0.1
Fishing	-5.9	7.4	15.6	5.3	5.4	5.7	5.7	3.5
Secondary production	**1.3**	**10.9**	**7.8**	**4.8**	**4.9**	**9.6**	**9.7**	**4.1**
Mining and quarrying	3.2	9.1	6.0	5.1	5.2	10.0	10.0	4.0
Manufacturing	0.0	4.2	1.3	3.8	3.8	6.0	6.0	2.8
Utilities	-1.2	2.1	8.3	3.6	3.8	7.0	7.0	4.0
Construction	3.4	20.2	12.7	5.9	6.0	13.0	13.0	5.0
Tertiary production	**1.6**	**2.7**	**3.7**	**3.4**	**3.5**	**3.7**	**3.8**	**2.8**
Trade	1.1	4.3	2.7	5.4	5.4	6.5	6.5	3.8
Hotels, restaurants	-0.4	7.7	7.2	4.7	4.7	3.0	3.0	2.8
Transport, communication	0.6	12.4	5.3	5.8	5.8	5.0	5.0	4.1
Financial intermediation	4.6	-3.9	12.6	6.6	6.6	7.0	7.0	6.5
Real estate, business services	1.5	6.4	7.2	1.5	1.5	2.0	2.0	2.0
Public administration	0.4	1.7	0.4	0.7	0.7	1.0	1.0	1.0
Education	12.0	-2.8	-3.1	2.0	2.0	2.0	2.0	2.0
Health and social work	8.3	-7.9	8.6	1.5	1.5	1.5	1.5	1.5
Recreational, cultural activities	1.4	6.7	5.1	2.0	2.0	3.0	3.0	2.0
Other community services	2.0	-6.3	6.7	2.0	2.0	2.0	2.0	1.5
Ownership of dwellings	0.4	1.0	1.8	2.0	2.0	3.0	3.0	1.0
Other*	4.1	6.5	4.6	1.0	1.0	1.0	1.0	1.0

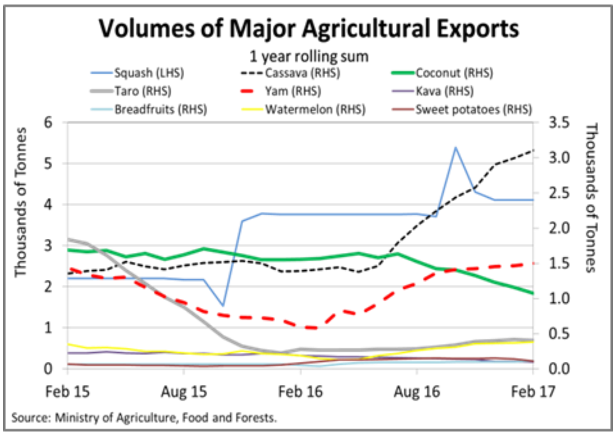
* Includes taxes minus subsidies and imputed bank service charges
Source: Department of Statistics, NRBT

first steps to implementing this plan. The key focal points included in this plan are to develop the Special Management Areas program, particularly for coastal and commercial fisheries and also the economic development of commercial fisheries and aquaculture. This sector also continued to benefit from the tax concessions on oil and fishing gear. Moreover, the Government Development Loan scheme assisted the access to finance of fishermen which is reflected in more fishing boats and the increased volume of fish available in the local market and exported overseas as indicated by exporters through the Reserve Bank's liaison program. Nonetheless, weather uncertainties still remain a risk to this sector. In addition, the marine shipments sometimes miss the flights for the export of fish by cargo to the overseas market therefore results in cargo space not being fully utilised.

The preliminary growth for the agricultural sector released by the Statistics department for 2015/16 was 0.3%. This is a rebound from a 4.8% contraction in 2014/15. However, the Reserve Bank is anticipated a stronger growth of 2.5% in the current financial year although there are risks to the expected growth.

In the period July-February of the current financial year, the total volume of agricultural export was 8,920.4 tonnes compared to 6,656.5 tonnes in the same period of 2015/16. Favorable weather conditions during the year relative to the previous year may have contributed to the improvement in the agricultural production. Every agricultural exported commodity surpassed the volume exported in the same period in 2015/16 except for sweet potatoes, pele leaves, cured beans, coconuts, and kava that were adversely affected by the drought.

Figure 6: Volumes of Major Agricultural Exports



Agricultural industry in the primary sector has the highest share of GDP. The increase in exported volume during the first 8 months of 2016/17 is in line with the $1.6 million (30.8%) rise to $6.6 million in agricultural export proceeds as reported by the banking system. The strengthening of the Japanese Yen (JPY) and the United States Dollar (USD) against the Tongan Pa'anga (TOP) supported the higher export receipts from the export of squash.

The performance in the agricultural sector is expected to grow by 2.0% in 2017/18 supported by an anticipated rise in domestic production and export volume. The support from the MAFF and continuous active growth committees such as Growers Federation and Hahake Growers assist the development in this sector. The agricultural exporters aim to improve infrastructure for farmers such as the packing house facilities. The re-opening of the High Temperature Forced Air (HTFA) facility would support the exports of papaya, breadfruit, and the new products to be introduced such as eggplant and chilies. In addition, Tonga is anticipated to sign the Pacific Agreement on Closer Economic Relations (PACER) Plus trade negotiation which may also support growth in the sector by removing tariff on exported watermelon to Samoa. The first shipment of squash to China was a success in December 2016 and may increase total squash exports volume. Moreover, youth awareness program about agriculture currently facilitated by the Growers Federation may help future growth of the sector. The Government's Development Loan scheme administered by the Tonga Development Bank (TDB) also supported the growth for the agricultural sector by providing affordable finance to the growers and agricultural exporters. However, the greatest risk to the outlook of this sector is the uncertainty in the weather conditions.

The forestry sector reported unfavorable growth in 2015/16 of negative 20.2% compared to a 16.8% growth in 2014/15. This was largely due to the decline in exported sandalwood. Over the first eight months of 2016/17, there has been no export of sandalwood. However, the Reserve Bank projects a 0.1% growth in 2016/17. According to liaisons with Tonga Power Limited, major network upgrade projects in Tongatapu scheduled for 2017/18 may increase the demand for poles supplied by Aotearoa-Tonga Forest Product Limited, hence contribute to the sector growth. The competition from overseas firms may pose a risk to this forecast.

Secondary Production

The construction activities in the country contributed to a strong performance in the secondary production. The industry grew by 8.0% in 2015/16 compared to the 11.5% growth in 2014/15. The Reserve Bank anticipates that the industry will grow by 4.9% in

2016/17 supported by the on-going construction activities and increased residential construction works. This is a slight upward revision from 4.8% reported in the August 2016 MPS.

The construction sector is projected to grow by 6.0% in 2016/17, an upward revision from the 5.9% growth projection in the August 2016 MPS. The anticipated growth is supported by an increase in business loans for construction, manufacturing, and utilities and also a rise in private household housing loans. The completed and on-going projects such as the renovation of the Tanoa International Dateline Hotel, church buildings, St. George Palace, LDS chapels, major upgrade and extension of Faua wharf, a new office building for the Utilities sector, construction of sports facilities and various other private construction works are expected to drive growth in 2016/17 and later years.

According to liaison with the Ministry of Infrastructure, there are major public and private construction projects already in the pipeline. Majority were for the construction of sports facilities such as the Tonga High School (THS) Sports Complex, upgrade of the Teufaiva Stadium, relocation of Tonga Side School and other projects. Private constructions also show interest in accommodation business, and construction by returning residence pensioners.

The construction works explained above is a strong indicator of trade and transport. It is also associated with the development in the mining and quarrying sector. However, delays in the completion of construction works can defer growth in the sector

The outlook for the manufacturing sector remains positive despite the slowing of growth to 1.3% in 2015/16 compared to 4.2% in 2014/15. The manufacturing sector is expected to grow by 3.8% in 2016/17 and reflect a stronger 6.0% growth in 2017/18. This is also supported by the rise in private individuals' housing loans and business loans for construction and manufacturing.

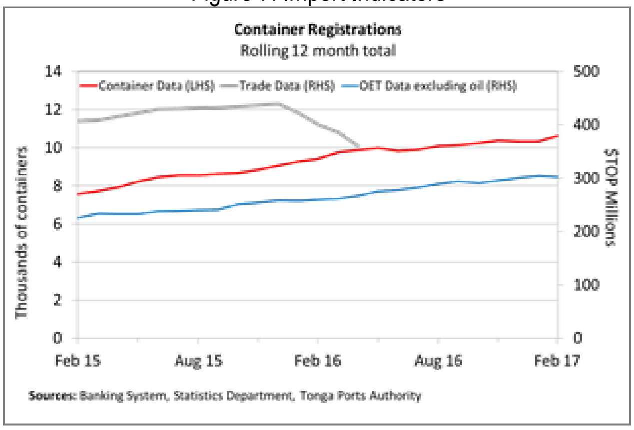
The developments in the construction sector are expected to also have spillover effects on the utilities, and other sectors of the economy. Despite the rise in electricity prices, consumption increased by 4.50 million kW in the first eight months of 2016/17 to February 2017 coinciding with a 4.34 million kW rise in electricity production and 861 rise in the number of electricity consumers. Growth in the sector is expected to be in line with developments in the construction sector and the movements in the global oil price.

Tertiary Production

Growth in the tertiary production was 3.8% in 2015/16 improving from a 3.0% growth in 2014/15. All sectors in the industry recorded growth except for education. The financial intermediation, tourism, health and social work were the lead growing sectors in 2015/16. The Reserve Bank anticipates the services sector to grow by 3.5% in 2016/17 and to grow stronger by 3.8% in 2017/18.

The trade sector recorded 2.7% growth in 2015/16 and the Reserve Bank forecasted stronger growth of 5.4% in 2016/17 and to grow further by 6.5% in 2017/18. Partial indicators reflect potential growth as consumption activities were increased. Eight months into 2016/17, the number of containers registered rose by 769 containers (12.3%) compared to the same period of 2015/16. This was due mainly to an increase of 604 private container registrations, implying a rise in the informal distribution sector and a rise in private construction. Business containers also increased by 165 registrations. The events that took place during the first eight months of 2016/17 may have contributed to this increase. This includes the LDS Tonga Mission Centennial celebration, school anniversary for Chanel College Kelana and Christmas holiday season.

Figure 7: Import Indicators

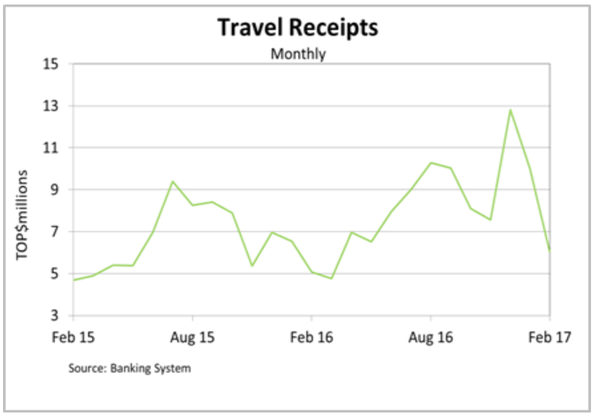


Moreover, total vehicle registrations were at 2,470 vehicles in the first eight months of 2016/17, which was 535 (27.6%) more than the eight months into 2015/16. The increase was largely supported by consumer's higher spending power. For instance, months following the return of Recognized Seasonal Employees (RSE) from overseas, vehicle registrations increased. Moreover, banks' lending for vehicle increased in the first eight months of 2016/17 by $0.3 million (46.3%) compared to same period of 2015/16, which may partly contribute to the higher registrations in vehicles. Expansion in the trade sector may also indicate growth in the transportation sector. The upgrade and extension of the Faua wharf is schedule to be completed in 2018, will contribute significantly to improving the safety and quality of domestic inter-island transportation, and further support economic activity.

Furthermore, annual events scheduled for the year including annual church conferences and the Heilala festival indicates potential increase in the distribution sector as well as the tourism sector.

Performance of the tourism industry in 2015/16 was slightly lower than 2014/15. This sector is expected to strengthen further in 2016/17 and 2017/18 supported by events taking place during the year, opening of the Tanoa international hotel, increased cruise ship arrivals, and plans to host international games domestically. Total international arrivals increased by 12,237 passengers over the first eight months of 2016/17 due mainly to an increase in cruise ship arrivals of 7,906 visitors (70.1%). This reflected a higher number of cruise ships arriving during the first eight months of 2016/17 where 13 cruise ships have arrived compared to 10 cruise ships in the same period in 2015/16. The visa waiver between China and Tonga introduced in June 2016 took its first effect in December 2016 as a cruise ship Costa-Atlantica arrived in Tonga with about 2,000 Chinese tourists.

Figure 8: Travel Receipts



Additionally, Tonga is now popular as a tourist destination and that Vuna wharf is now more reliable for international cruise liners than it was before. Furthermore exports of mats, tapas, and handicraft rose by 6.0 tonnes (8.8%) in July 2016-February 2017 compared to the same period of 2015/16. There is also potential for further boost in growth in the handicrafts sector in line with the expected growth in the tourism sector.

Growth in the tourism sector is consistent with a $16.0 million (27.7%) rise in travel receipts in the first eight months of 2016/2017. This was also supported by the strengthening of the NZ, US and Australian dollar against the Tongan pa'anga. The greatest risk to tourism is Tonga's vulnerability to natural disasters.

Higher credit growth continued to support growth in the financial intermediation sector. Following negative growth in 2014/15, the sector showed strong growth in term of real GDP by 12.6%. Competition amongst banks, driving lending rates lower, supported growth in this sector. Additionally, the low interest Government Development Loan scheme increased activities in this sector. According to the banking system, there is excess liquidity in which Reserve Bank expects to support further lending in the future.

Unemployment

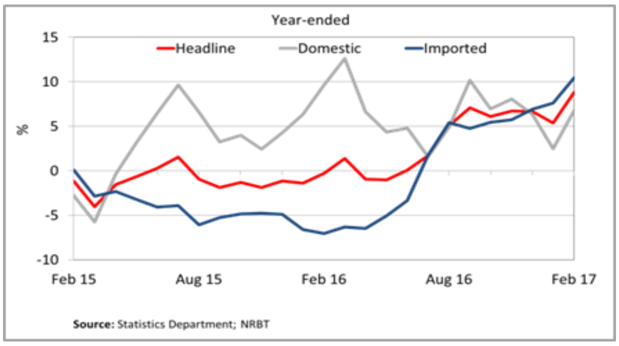
Employment growth weakened in 2015/16, consistent with the slowing of domestic economic activity. The unemployment rate remained unchanged at 6.5% as reported in the latest MPS. According to the Reserve Bank's survey of job advertisements in the past six months, recruitment intentions were largely observed in the public administration and business services sector. The high numbers of job advertisements in the public administration are potential new recruitment by the Government in 2017/18 and incorporated in their respective budgets. Over the year to February 2017, recruitment intentions rose by 40 job advertisements mainly on services sector. The Reserve Bank expects the positive outlook for the economy supports the expectation for increased demand for labour in the near term and thereby lower unemployment rate.

3. Promoting Low and Stable Inflation

Recent Developments

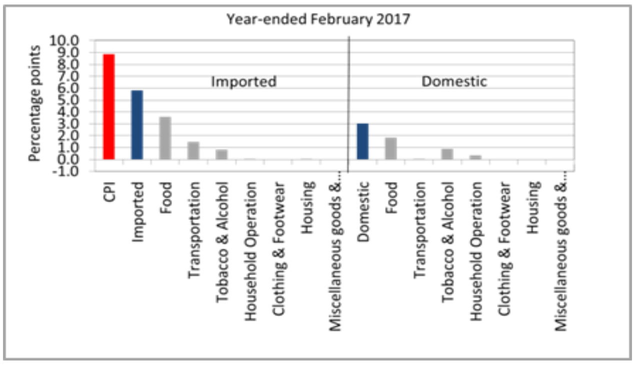
Inflationary pressures continued to increase in February 2017 due mainly to the new custom duties and excise taxes introduced in July 2016, rise in global oil and food prices, seasonality of local food, and shortage of kava-Tonga supply.

Figure 9: Inflation



The annual inflation rate increased significantly by 8.9% in February 2017 compared to a 0.3% deflation in February 2016 and a 5.1% rise in August 2016. The local and imported food prices have the largest share of weights in the consumer price index (CPI) basket thus have the highest contribution of 5.4 percentage points to the annual inflation rate.

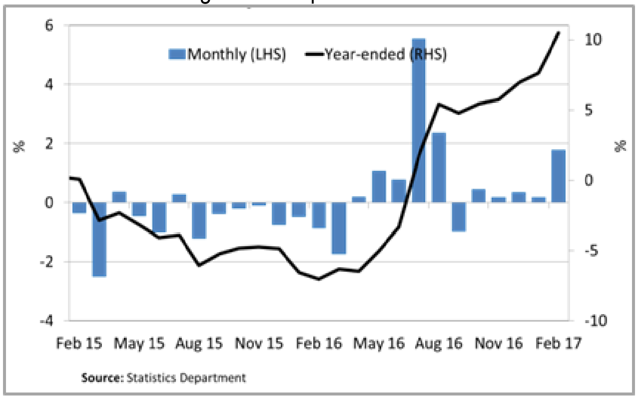
Figure 10: Contributions to Inflation



Since the introduction of new custom duties and excise taxes on certain food items and tobacco, the inflation rate started to increase compared to periods of deflation in the same month of the previous year. Additionally, the rise in global oil prices drove the higher fuel and electricity prices and contributed to the higher imported inflation. Moreover, seasonality in local produce and kava-Tonga prices were the major drivers of the rise in domestic inflation.

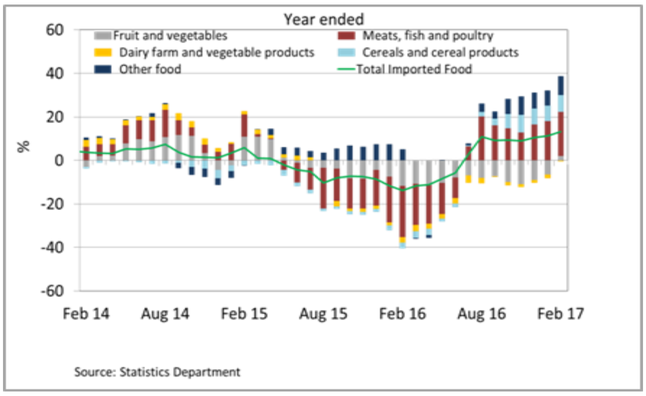
Imported inflation had been recording an annual deflation each month since March 2015. However, in July 2016 it rose by 1.7% mainly driven by the higher prices of imported meat and tobacco.

Figure 11: Imported Inflation



In February 2017, the annual imported inflation increased by 10.5% driven by the increased prices of food, fuel, and tobacco. Imported food prices rose by 13.2% contributing 3.6 percentage points to the annual headline inflation. The meat, fish & poultry category had the highest increase of 20.2%, followed by an 8.8% increase in the prices of other food components for items such as sugar and flour. The cereal and cereal products category also rose by 7.6% largely reflecting the increased global food prices. According to the Food and Agricultural Organization (FAO) of the United Nation's website, the FAO Food price index in February 2017 was at its highest value in almost two years rising by 17.2% above its February 2016 level[3].

Figure 12: Imported Food



Additionally, the second highest driver of imported inflation was the price of private transport which comprises of petrol and diesel. Fuel prices rose by 21.0% over the year to February 2017, contributing 1.5% to the annual headline inflation. This was reflected in the increased price of petrol and diesel over the year of 20.2% and 28.9% respectively. The high fuel prices were due to higher world oil prices which flow through to local oil prices with a lag of 1-2 months. A year ago in February 2016, the Brent crude oil was

[3] http://www.fao.org/news/story/en/item/472449/icode/

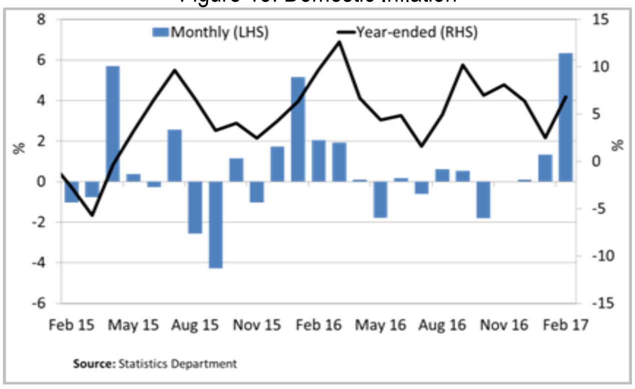
US$35.10 per barrel compared to US$56.07 (59.7%) in February 2017.

The annual underlying inflation (excluding imported fuel and food prices) rose by 6.3%, reflecting the influence global food and oil prices have on inflation.

Moreover, excise tax on tobacco has driven the tobacco price upward by 25.8%. This is evident in the 27.5% rise in the price of Winfield blue over the year to February 2017. Furthermore, the strengthening of the USD, AUD, NZD against the TOP contributed to the imported prices higher.

Similarly, the domestic prices rose by 6.8% over the year to February 2017. This was driven by the local food category which rose by 9.0% contributing 1.8 percentage points to the annual headline inflation. The cereal products category had the highest increase of 18.0%, which included prices of goods from the bakery. This reflected the impact of the increased price of imported flour and sugar. This was followed by a 9.6% rise in the prices of fruit and vegetables due to seasonality in local produce. The meat, fish, & poultry components also rose by 6.5%. Meals away from home rose by 2.8% due to the increased demand for readily prepared meals.

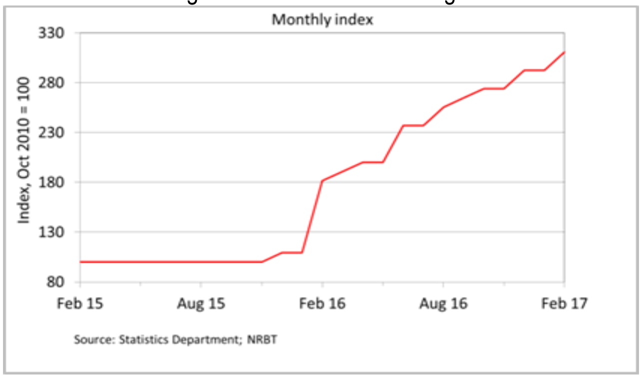
Figure 13: Domestic Inflation



In addition, due to the shortage of supply and excess demand for kava-Tonga, its price continued to remain high since the hike in the beginning of 2016. According to the Reserve Bank's liaison program, the supply of kava-Tonga is expected to remain low in the near term thus contributing to the higher domestic inflation.

Additionally, the high fuel price is reflected in the price of electricity, which increased by 5.5% over the year to February 2017. According to the WEO report in April 2017, the recent increase in the price of oil reflects the agreement between producers to control the volume of oil supplied to drive the price upward. Hence, higher oil prices in conjunction with the weak TOP are expected to increase transportation costs and food prices thus driving the imported prices higher.

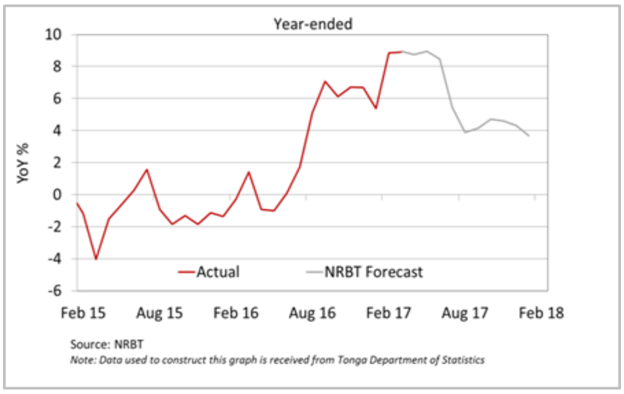
Figure 14: Price of kava-Tonga



Outlook

The Reserve Bank expects the upward inflationary pressure to remain in the near term due to the impact of the increased custom duty and excise tax effective in July 2016. However, the annual headline inflation is forecasted to gradually decline below the reference rate of 5% per annum after August 2017. The movements in global food and oil prices may pose a risk to this outlook. Additionally, the vulnerability of Tonga to natural disasters poses a risk to the local food prices and consequently the inflation outlook. The Reserve Bank will closely monitor the sources of higher inflation which include assessing the effects of exchange rates, new tax introduced and also the businesses' profit margins.

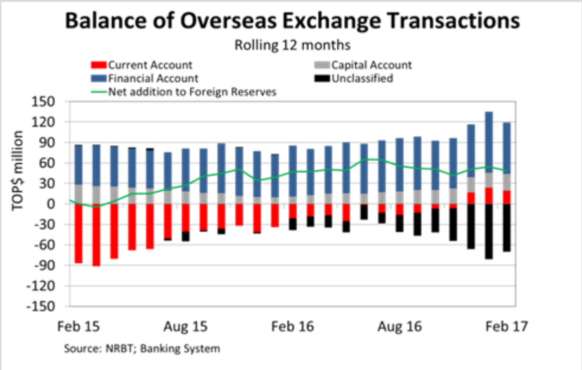
Figure 15: Headline Inflation Forecast



4. Maintaining Adequate Level of Foreign Reserves

The Reserve Bank continued to closely monitor the country's external monetary position in its function to maintain an adequate level of foreign reserves above 3-4 months of imports cover. The following data and estimates of the balance of payments are based on the OET data collected by the Reserve Bank from the banks and authorized restricted Foreign Exchange Dealers (FEDs).

Figure 16: Balance of Overseas Exchange Transactions



Balance of Overseas Exchange Transactions

The overall balance of OET over the past six months to February 2017 was a surplus of $11.4 million, which contributed to a rise in the official foreign reserves to $377.7 million by the end of February 2017. This was three times lower than the surplus recorded for the past six months to August 2016 of $37.7 million.

Over the year to February 2017, the overall balance also recorded a surplus of $49.1 million, which is a slight increase of $1.9 million (4.0%) from the surplus of $47.2 million over the year to February 2016. The rising surplus in the capital account over the year was the major driver of the higher annual overall surplus.

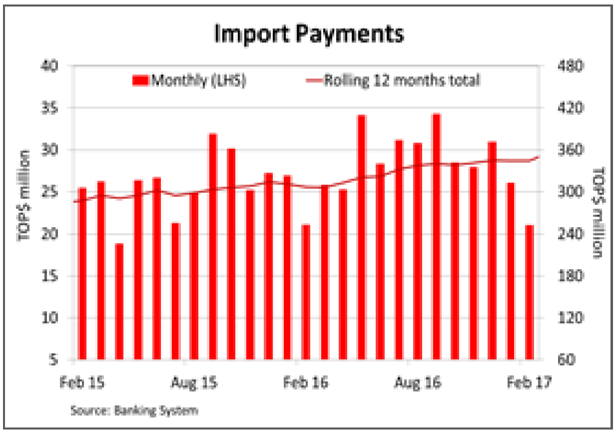
Current Account

The balance of the current account over the last six months to February 2017 soared by $14.7 million to a surplus of $17.3 million from the last six months to August 2016. This was largely attributed to higher inflows of remittances, official grants and budgetary support for the Government.

Over the year to February 2017, the current account balance recorded a surplus of $20.0 million compared to a deficit of $21.1 million in the same period of the previous year. The significant increase in transfers receipts particularly official, private and non-profit organisations' transfers was the main driver of this improvement in the current account. In addition, services receipts also contributed to this growth although it was slightly lower than the previous year. This outweighed the impact of higher import and private income payments.

In the past six months to February 2017, majority of the current account payments were for import payments totaling to $168.7 million, 3.8% lower than it was in the six months to August 2016. The lower import payments over the past 6 months were due mainly to lower payments for import of oil and other imported goods mostly by the Government. On the other hand, payments for import of wholesale & retail goods, vehicles and construction materials increased over the past six months to February 2017 which is in line with the improved domestic economic activities. The events that took place during these months such as the Christmas and New Year season, family reunions and also the ongoing construction projects such as the St George Palace, the extension of Faua domestic wharf and private constructions have driven the higher demand for consumption goods and also construction materials. The 15.6% growth in housing loans supported the increase of imported construction materials. Easier access to online trading facilities, increased competition with the local car dealers and higher demand for cars from individuals including the rising number of RSE workers contributed to the higher imports of second hand motor vehicles.

Figure 17: Import Payments

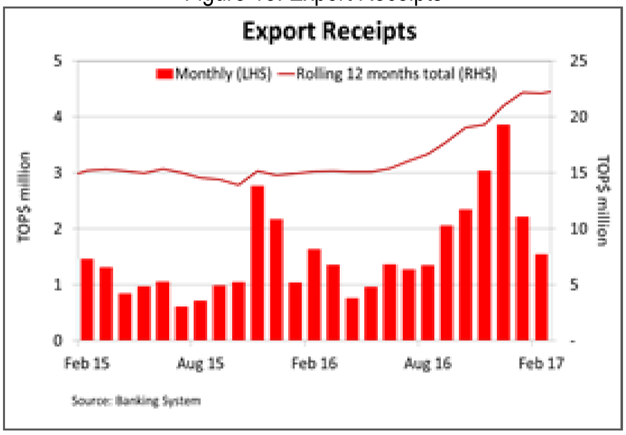


In the year ended February 2017, import payments rose by 12.2% to $344.1 million, due to a rise in import payments for wholesale and retail goods, construction materials and also motor vehicles. This partially offset the declines in import payments for oil and other imported goods. The improved growth in the distribution sector contributed to the rise in wholesale and retail trade imports payments, which coincided with the 12.6% rise in container registrations. Additionally, the removal of custom duty on construction materials and higher number of construction permits over the year contributed to the higher payments for imports of construction materials.

Total export proceeds for the past six months to February 2017 rose significantly by 113.2% to $15.0 million. This was mainly attributed to the harvesting season of squash and other exported goods. Proceeds from fish and other marine exports slightly improved indicating growth in the fisheries sector.

Over the year to February 2017, total export proceeds also rose by $7.0 million (46.1%) to $22.1 million. This was due to an increase in the proceeds for agricultural exports of $4.9 million (86.2%), marine exports of $1.7 million (25.6%) and other exports of $0.4 million (15.1%). This is consistent with the stronger growth in the agricultural and fisheries sectors. The more favourable weather conditions may have contributed to the improvement in export receipts.

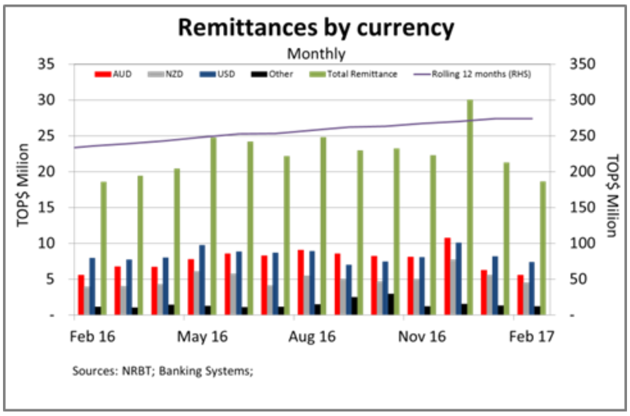
Figure 18: Export Receipts



Transfer receipts played a major role in the performance of the current account. Over the six months to February 2017, transfer receipts declined by $2.7 million which was mainly due to a decrease in official transfers by $12.1 million (23.5%). This outweighed an increase in private and non-profit transfer receipts of $9.0 million. The decline in the official transfers was attributed to lower inflows of budgetary support and government grants during the period. Remittance receipts however drove the rise in private transfers as it increased by 5.3% to $128.9 million. This included $2.2 million receipts from residents working in the Regional Seasonal Employee's (RSE) scheme overseas, compared to $5.5 million in the 6 months prior. The rise in non-profit transfer receipts reflected the increase in grants received by non-profit organizations mostly churches and schools for technical assistance and other current expenditure. The strengthening of the USD and the AUD against the TOP over the six-month period ended February 2017 also benefitted Tonga as a recipient of foreign currency.

Total transfer receipts in year ended terms rose to $388.1 million, 30.5% higher than the previous year. The inflow of remittances continued to rise to $273.8 million in the year ended February 2017, despite the de-risking decisions which has resulted in the closing of some of the authorized restricted foreign exchange dealers' bank accounts. This was 16.3% higher than the previous year and represented 37.2% of the total OET receipts. The remittances to Tonga may not be sensitive to exchange rate fluctuations but driven by the basic needs of families and friends, major celebrations throughout the year such as the Tupou College's 150th Anniversary, Queen Mother's birthday, LDS Centennial Celebration together with the churches' annual conferences. Total receipts from RSE workers slightly decreased to $7.7 million for the 12-month period ended February 2017 compared to $7.8 million in the previous year. It is estimated that remittances as a share of GDP for 2015/16 was 44.2%, rising from 25.0% in the previous year. Official transfers also rose to $90.8 million over the year due to receipts of government budget support, grants and donor funds for government projects.

Figure 19: Remittances by currency



Over the 6 months to February 2017, net services receipts soared from $6.7 million in the six months to August 2016 to $12.0 million. Personal travel receipts drove this as it rose significantly by 56.2% to $52.2 million, and this was in line with the 13.8% increase in the number of passengers arriving in the country during these months.

For the 12-month period ended February 2017, the surplus in services slightly decreased to $18.7 million from $20.8 million in the year ended February 2016, underpinned by higher travel payments.

Capital Account

Capital receipts rose by $2.7 million to $14.8 million over the six months to February 2017 which was attributed to receipts for private capital investments. This included receipts by the construction companies that are currently construct the government projects such as the upgrading of new domestic wharf, St George Palace, and new hospital for Niuatoputapu. Capital payments also rose over the same period to $2.6 million. Therefore, the capital account balance recorded a surplus of $12.2 million over the six months to February 2017.

In year ended terms, the capital account recorded a surplus of $24.1 million, which was 115.1% higher than the surplus for the year ended February 2016. This was attributed to higher private capital receipts mainly in private grants for investment projects and capital expenditures compared to the previous year.

Financial Account

Financial account receipts declined over the six months to February 2017 by 6.5% to $56.2 million due to lower inflows of foreign direct investments. Financial payments also declined slightly by 2.1% to $20.5 million which were mostly in the form of interbank transfers. As a result, net surplus in the financial account slightly declined also by $3.5million to $35.8 million over the six months period ended February 2017.

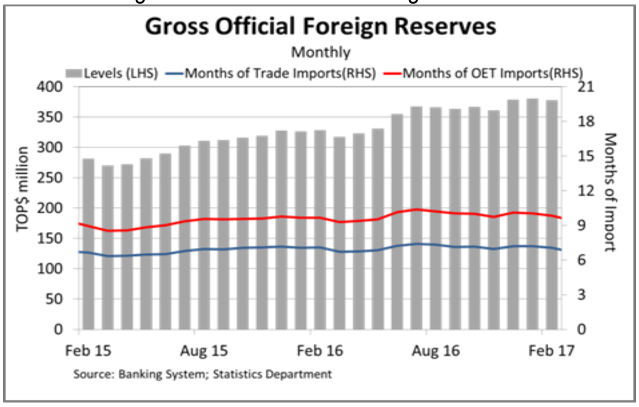
In the year ended February 2017, the financial account balance recorded a surplus of $75.0 million, which is 1.1% slightly higher than the surplus in the year ended February 2016, reflecting growth in foreign direct investment.

The balance of unclassified transactions was an average outflow of $5.8 million per month over the 12 months to February 2017, compared to $1.4 million in the previous year. This was due to higher financial claims by non-residents which involves foreign exchange dealings between commercial banks and their overseas correspondent banks.

Official Foreign Reserves

Gross official foreign reserves continued to rise reaching $377.7 million in February 2017, compared to $366.3 million in August 2016. This was sufficient to cover imports of merchandise goods and services for 7.1 months[4], well above the Reserve Bank's minimum range of 3-4 months of imports. In year ended terms, gross official foreign reserves rose by $49.1 million. The lower deficit in the current account balance as a result of higher remittances, higher receipt of foreign aid from donor partners and budgetary support for the government, contributed to the higher foreign reserves over the past year.

Figure 20: Gross Official Foreign Reserves



Exchange Rates

The Nominal Effective Exchange Rate (NEER) index rose by 1.1% over the six months to February 2017 as the majority of the major currencies particularly the NZD, FJD, CNY, EUR, GBP and JPY depreciated against the TOP. The Real Effective Exchange Rate (REER) index also rose over the same period by 4.1% reflecting the impact of Tonga's higher inflation relative to its major trading partners. Over the year, the NEER fell by 1.3% while the REER rose by 5.6% 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 2018 based on the following key factors:

- Remittances are expected to remain at high levels over the coming months due to upcoming festivities and scheduled events for 2017 such as school anniversaries and annual church conferences. Rising number of people joining the RSE schemes also contributes to higher remittances.
- Expected growth from agricultural and fisheries activities can boost export proceeds and this will be partially offset by the projected rise in import payments.
- Banks and foreign exchange dealers expanding their range of products and services offered to customers will also support remittances and other financial receipts.
- Tourism activities such as whale watching, proceeds from artisanal handicrafts, sea cruises, more airline

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

routes, new hotels and restaurants will positively impact travel receipts.

- Government receipt of aid funds in the form of budget support and other assistance from donor partners are expected in the coming months and next financial year for on-going construction projects.

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

- Delays to the inflow of aid and budget support from development partners combined with the pace of development in domestic economic activities poses a risk to the foreign reserves outlook.
- The significant rise in external debt service to Export - Import (EXIM) Bank of China in financial year 2018/19.
- Vulnerability to natural disasters which can greatly impact export and travel receipts.
- Uncertainty in the forecast of world fuel and commodity prices can harm Tonga's external position as a price taker.

5. Promoting a Stable Financial System

Over the 6 months to February 2017, the banking system remained sound with strong capital position and high liquidity maintained, supported by comfortable profitability, and non-performing loans continued to remain low. This was backed by continuous rise in total lending thereby reaching a new record high in February 2017, as well as growth in deposits which was in line with the high level of foreign reserves. The weighted average interest rate spread however slightly rose over the period.

Table 3: Consolidated Balance Sheet of Depository Corporations

	Level			YoY change	
	Feb 16 $TOPm	Aug 16 $TOPm	Feb 17 $TOPm	Feb 16 $TOPm	%
Broad money liabilities	**456.5**	**491.0**	**510.2**	**53.7**	**11.8**
Currency in circulation	47.6	48.4	50.9	3.3	6.9
Demand deposits	182.3	194.8	193.9	11.7	6.4
Savings and Term deposits*	226.6	247.8	265.3	38.7	17.1
Equals					
Net foreign assets	**330.3**	**377.9**	**402.2**	**72.0**	**21.8**
Plus					
Net domestic assets	**126.5**	**113.4**	**108.3**	**-18.2**	**-14.4**
Gross bank lending**	340.5	364.1	394.6	54.1	15.9
Other***	-214.0	-250.7	-286.4	-72.4	33.8

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

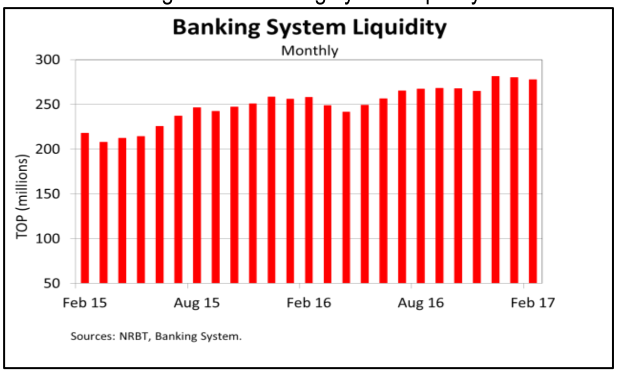
Money Supply

Broad money continued to rise over the last 6 months to February 2017 by $19.2 million (3.9%) to $510.2 million compared to $491 million in August 2016. Additionally, during the last 6 months, broad money reached a new record high of $512.2 million in December 2016. The rise in broad money over the last 6 months to February 2017 was driven by a $24.3 million (6.4%) increase in net foreign assets offsetting a $5.1 million (4.5%) decline in net domestic assets. Foreign reserves continued to rise which drove the increase in net foreign assets whilst higher government deposits led the decline in net domestic assets.

Throughout the year to February 2017, broad money rose by $53.7 million (11.8%). This was driven mainly by net foreign assets which increased by $72.0 million (21.8%) offsetting the yearly fall in net domestic assets of $18.2 million (14.4%). The continued annual rise in foreign reserves drove the strong growth in net foreign assets which coincided with the increase in currency in circulation and deposits particularly savings and term deposits.

The banking system liquidity (reserve money) increased over the last 6 months to February 2017 by $10.8 million (4.0%) to $278.0 million greater than $267.2 million reported in the August 2016 MPS. However, throughout the last 6 months, liquidity in the banking system hit a new level high of $281.3 million recorded in December 2016. This also coincided with the new record high of broad money stated for the same month. Higher deposits over the past 6 months further support the growth in reserve money.

Figure 21: Banking system liquidity



Total loan to deposit ratio fell very minimally in February 2017 to 73.3% from 73.7% in August 2016. In February 2016, the loan to deposit ratio was at 73.6% which is slightly higher than the current ratio. This remained below the 80% minimum loan to deposit ratio target which indicated excess liquidity in the banking system remains. Despite the strong growth in the banks' loan books, this was outweighed by the continuous growth in deposits, which coincided with the higher foreign reserves. This indicates more capacity remains for further lending by the banks, however, the Reserve Bank will continue to monitor the lending growth to avoid any overheating in the economy. Annually, liquidity in the banking system rose by $19.7 million (7.6%) driven by growth in bank deposits.

Another initiative taken by the Reserve Bank in its efforts to help improve the image of Tonga to the world is by ensuring that good quality banknotes and coins are in circulation. These efforts include distributing mint quality banknotes and coins to the public directly through retail shops, Talamahu market and through church functions such as their annual charitable donation events and conferences; direct deposits of mint quality notes to the Reserve Bank's note trust depots in the outer islands from which the outer islands can interchange and replace mutilated notes with good quality notes on a timely manner.

Interest Rates

The weighted average lending rate increased by 1.0 basis point (from 7.90% to 7.91%) which outweighed the rise in the weighted average deposit rate by 0.5 basis points (from 2.208% to 2.213%) over the past 6 months to February 2017. Consequently, this resulted in the banks' weighted average interest rate spread to widen marginally by 1.0 basis point to 5.70% from 5.69% in August 2016. Business lending rates increased over the past 6 months, particularly for loans to the manufacturing and professional & other services sectors. The weighted average deposit rate increased due to higher demand and term deposit rates. Furthermore, the high level of bank deposits supported the slight rise in the weighted average deposit rate.

Over the year, the weighted average lending rate declined by 11.5 basis points and the weighted average deposit rate rose by 2.3 basis points. As a result, the weighted average interest rate spread narrowed by 13.9 basis points annually. The weighted average lending rate declined which was led by lower lending rates for households particularly housing. This reflects the housing loan campaign by banks which supported the strong growth in housing loans. Additionally, lower lending rates for businesses contributed to the annual decline, driven mainly by a decrease in the lending rates for agriculture, fisheries, utilities, and tourism loans. The low interest rates on Government Development Loans contributed to the lower weighted average lending rates particularly for the agricultural, fisheries and tourism sectors.

Figure 22: Weighted Average Interest Rates Spread

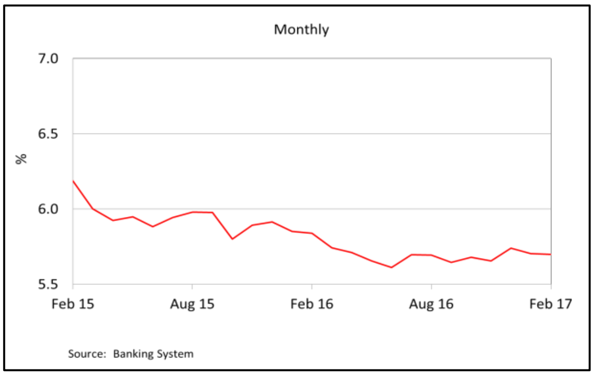
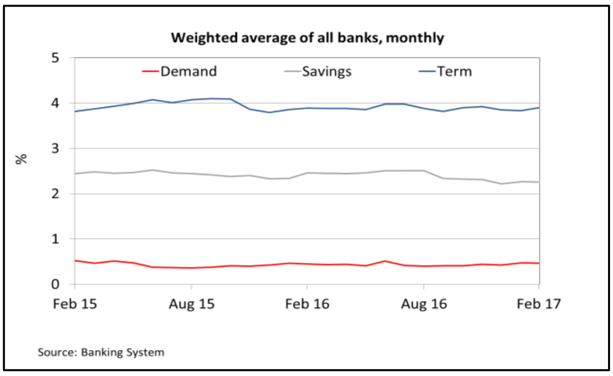


Figure 23: Deposit Rates



The weighted average deposit rate however rose over the year, driven by rises in the demand and term deposit rates which outweighed a decline in the savings deposit rate. More specifically, the weighted average demand deposit rate and the weighted average term deposit rate increased by 6.5 and 1.6

Table 4: Lending Rates
Weighted average of all banks

	Level as at			Change over 6 months to		Loan share	
	Feb 17 %p.a.	Aug 16 %p.a.	Feb 16 %p.a.	Feb 17 Bps	Aug 16 Bps	Feb 17 %	Aug 16 %
All	7.91	7.90	8.03	1.1	-12.6	100	100
Housing	8.03	8.08	8.18	-4.3	-10.2	43	41
Other personal	11.03	11.00	11.03	3.3	-3.1	16	16
Business*	6.97	6.94	7.17	3.5	-23.1	26	27
Other	6.25	6.54	6.25	-28.6	28.6	15	16

*Included Statutory Non-financial Corporation and Other Financial Corporations basis points respectively. This was further supported by consistent growth in foreign reserves as well as the high level of total deposits which continued to rise over the past 6 months to February 2017 recording a high level of $524.3 million.

Lending

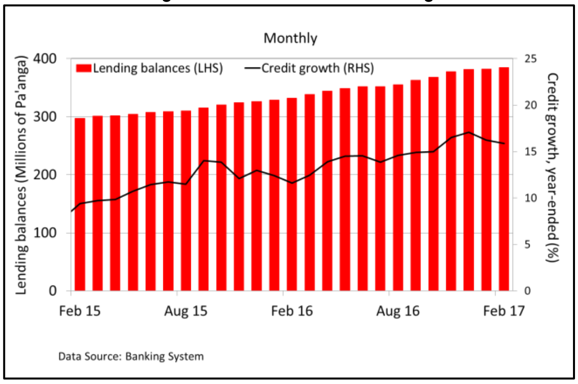
Total bank lending recorded its highest level in February 2017 at $384.5 million, which increased by $29.3 million (8.2%) from August 2016. This is higher than the $23.3 million (7.0%) rise in the 6 months to August 2016. The significant growth in lending was due mainly to the rises in household loans of $23.6 million (12.1%) and business loans of $5.9 million (3.7%). Only 2.6% of total loans were funded from the Government Development Loans as at the end of February 2017, increasing from 2.1% in August 2016.

Business lending reached $165.5 million in February 2017 higher than the level of $159.6 million in August 2016. The increase in business lending mainly stemmed from loans to the manufacturing, construction, tourism, trade, and transport sectors. This reflects growing economic activities within the private sector. This further indicates preparation by the country to host a number of conferences and events in the near future. This includes the Pacific Regional Energy and Transport Ministerial Meeting, Oceania Judo Championships, PACER-PLUS Agreement Signing, and the construction of sports facilities. Additionally, the private sector has been undergoing renovations and expansions of their buildings or businesses such as Kongakava Boutique Hotel, Friends Café, and Kupu House. Despite a slight rise in the weighted average lending rate over the past 6 months, it still remained relatively low enabling a high level of lending for businesses. Low interest rates on Government Development Loans further supported higher lending to business sectors.

The higher level of lending to households indicates an increasing demand for housing, vehicles, and other consumption items. The continued rise in all household loan categories over the 6 months to February 2017 led banks' lending to households to a new record high of $217.9 million, compared to $194.3 million recorded in August 2016. Housing loans contributed the most rising by $21.4 million (15.6%). The decline in the weighted average lending rate for individual housing loans by 4.3 basis points supported this rise. Other household personal loans increased by $1.9 million (3.4%), which reflected high consumer demand due to cultural activities, events, and the festive season that occurred throughout the past 6 months. Vehicle loans also increased over the 6 months to February 2017 by $0.3 million (46.3%), higher than the $0.2 million (60.8%) growth in the 6 months to August 2016. This coincided with a 245 (14.7%) increase in vehicle registrations. Other variety of vehicle transportations were introduced in November 2016 such as solar powered Tuk Tuks.

New business loan commitments rose over the 6 months to February 2017 by $11.4 million (672%) to $13.1 million driven by increases in new commitments to most of the sectors except for tourism.

Figure 24: Household Lending

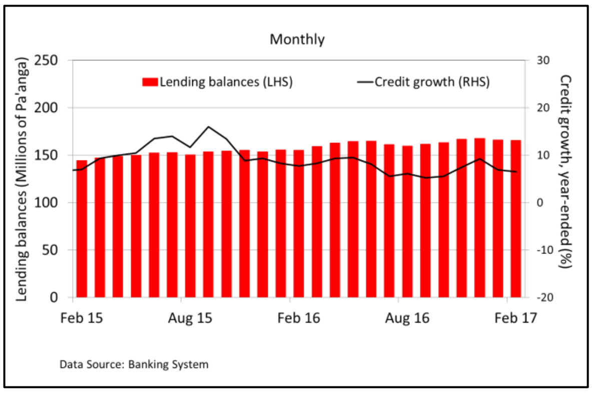


Over the year, total bank lending rose by $52.6 million (15.9%) which was significantly driven by an increase in household loans of $42.6 million (24.3%). Business loans also contributed to the annual rise by $10.1 million (6.5%). Higher lending to households over the year was a result of increases in all household lending categories particularly housing loans increasing the most by $40.0 million (33.7%). This is strongly supported by the on-going constructions works and higher import payments for construction materials over the year. This was consistent with a rise in new loan commitments of $8.6 million (66.7%), which were mainly business loan commitments.

The growing activities in these sectors were partially supported by the lower interest rates from the Governments Development Loan scheme. Lending activities in the non-bank financial institutions[5] also increased over the year by $16.2 million (13.5%). This was driven by an increase in household loans by $16.9 million (25.5%) offsetting a fall in business loans.

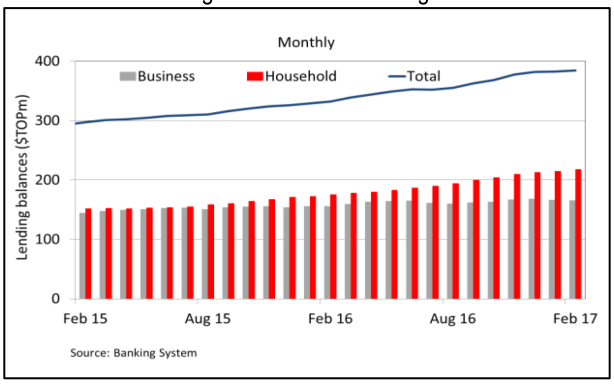
[5] This includes SPBD, RFB & Government on-lent loans

Figure 25: Business Lending



The total funds allocated for the Government's development loan scheme was about $13 million which was effective in August 2014 for a term of 6 years, which has not been completely utilized as at the end of February 2017.

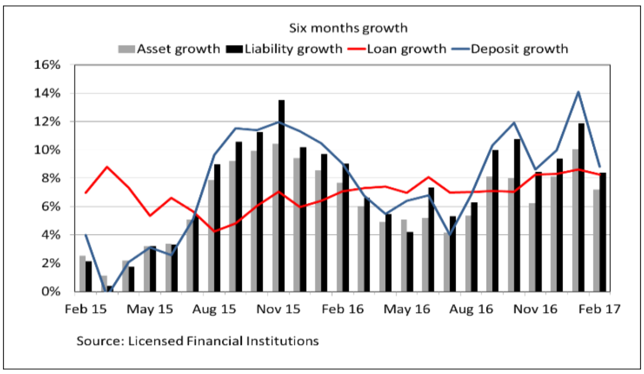
Figure 26: Bank's lending



Banking System Performance

The banking system remained sound during the six months to February 2017. Total assets of the banking system increased by $50.6 million (7.2%) to $754.1 million over the six months to February 2017.

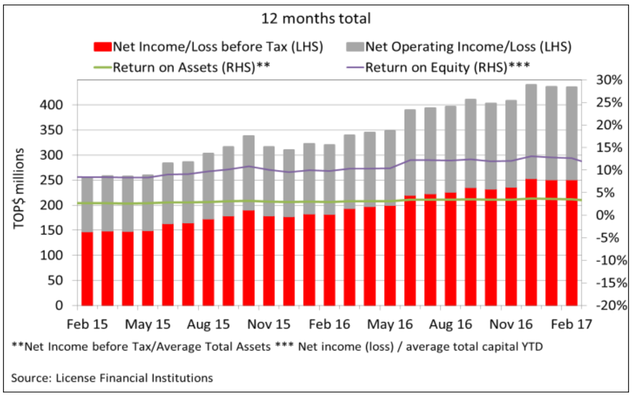
Figure 27: Total Banking System Balance Sheet Development



This was due mainly to an 8.2% ($29.3 million) growth in total loans as well as banks' higher deposits with the Reserve Bank (Exchange Settlement Accounts and Statutory Reserve Deposits) of $9.8 million and a rise in deposits with banks abroad of $12.5 million. Similarly, total liabilities increased by 8.4% ($46.7 million) to $604.1 million which is largely attributed to an 8.8% ($42.4 million) growth in total deposits over the past six months to February 2017.

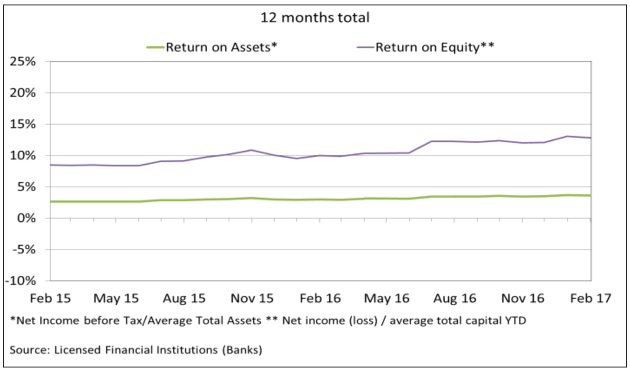
The total banking system remained profitable over the year to February 2017. The Net Profit After Tax was $18.4 million, an increase from $16.1 million in August 2016, and $13.8 million in February last year.

Figure 28: Total Banking System's Profitability



Both the Return on Assets (ROA) and the Return on Equity (ROE) slightly increased over the past six months. The ROA was 3.6% and the ROE was 12.7%, both rising from 3.5% and 12.1% respectively in August 2016. The improved profitability over the past six months to February 2017 was due mainly to lower non-interest expenses mainly that of personnel expenses, depreciation expenses and outsourcing & management fees.

Figure 29: Total Banking System's ROE & ROA



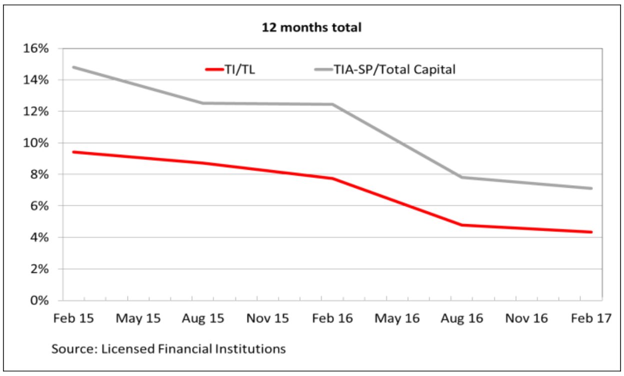
The net interest margin slightly fell to 3.0% in February 2017 from 3.1% in August 2016, due mainly to lower return on funds, and remained stable compared to February 2016. This reflected no significant changes to the interest rates for both loans and deposits. The

Reserve Bank considers the banks' lending interest rate levels to be reasonable given the risks associated with the credit environment in Tonga.

The banking system's capital position remained strong as the risk-weighted capital ratio was at 33.8% in February 2017, rising slightly from 33.2% in August 2016, which remained well above the Reserve Bank's minimum requirement of 15%. The increase reflects the transfer of banks' profit over the year to their retained earnings building up their eligible capital. This outweighed the rising risk weighted assets as banks' total loans continued to grow over the six months to February 2017.

The overall quality of the bank's assets improved over the past six months to February 2017. Total non-performing loans fell by $0.2 million (1.5%) to $16.7 million over the six months to February 2017. This is equivalent to 4.3% of total loans compared to 4.8% in August 2016 and 8.0% a year ago.

Figure 30: Total Banking System Asset Quality Indicators



The large portion of non-performing private business loans fell to 52.4% from 58.3% six months ago and comprised mainly of loans for Tourism, Professional and other services, Construction, and Distribution. Non-performing private individual loans accounted for 47.6% of total performing loans, higher than the 41.7% recorded in August 2016. Housing loans and personal loans were the main drivers rising by $0.6 million and $0.8 million respectively over the past six months. Provisions against loan losses fell over the past six months by $0.6 million and by $2.7 million over the year to $14.4 million. This was due to the improvement in the status of some provisioned loans which were therefore upgraded to performing status as well as the write offs during the year. The total coverage ratio which shows the capability of the banks' total provisions to cover non-performing loans rose to 86.1% from 66.5% last year. The value of collateral held against the delinquent loans reported by banks was at $40.5 million compared to total non-performing loans of just $16.9 million. This indicates that banks hold sufficient collateral to cover for any shortfall in loan loss provisions.

The Reserve Bank continues to monitor and manage the payment system to ensure it is functioning in an efficient, sound and safe manner.

Outlook

The Reserve Bank's credit growth forecast for 2016/17 still stands at 15% as published in the August 2016 Monetary Policy Statements (MPS), which is higher than the IMF Article IV projection of 10.8% for 2016/17. The Reserve Bank's policy measure that was effective on 1st July 2016 which set a minimum requirement on banks' loans/deposit ratios to encourage further lending, should support the anticipated continued growth in credit and broad money. The Reserve Bank's initiative to encourage lending to Micro, Small and Medium Enterprises is also expected to contribute to credit growth. At the same time, it is important for the structural reforms in different sectors as well as other impediments to lending such as the improvement to the land administrative system and a bankruptcy law to improve the confidence of the banks to lend further in a prudent manner. The Reserve Bank is currently exploring ways to enhance the role of the credit bureau in Tonga which should also support the credit environment.

The Retirement Fund Board (RFB) and the National Retirement Benefit Fund (NRBF) investment initiatives at the Tonga Development Bank will further support credit growth in the next six months. The banks' prospects for credit growth remain positive and the Reserve Bank's projection is supported by the continuous improvements in business confidence, improving economic conditions and annual events.

Broad money is also projected to increase in June 2017 by 14%, as previously projected, supported by the anticipated rise in lending and foreign reserves. This is higher than the IMF Article IV's projection for broad money to rise by about 9% in June 2017.

Supervision of Non-Bank Financial Institutions (NBFIs)

The supervision and oversight of all non-bank financial institutions remains work in progress. The legislations approved by Cabinet for the supervision of money lenders, credit union, microfinance institutions and foreign exchange dealers still await approval by the Legislative Assembly, tentatively for the 2017 parliamentary session. The Reserve Bank's position remains that the regulation of NBFIs is required to ensure the customers of these NBFIs are better informed of the risks associated with the NBFIs' products and that their interests are protected. This includes concerns with high interest rates charged by the informal lenders. The Reserve Bank recognizes that regulation of NBFIs should be to a relatively lesser extent compared to bank supervision, as they are serving certain sectors of the economy or community whom are not serviced by the banks. The Reserve Bank is of the opinion that the regulation of insurance companies, retirement funds and microfinance institutions are important to minimise potential systemic risks. The licensing and supervision of foreign exchange dealers continue under the current Foreign Exchange Control Regulations, which are being amended to improve the Reserve Bank's regulatory and enforcement powers. The draft Financial Consumer Protection policy for financial service provide is being finalized, to enhance the protection of financial consumers and thereby maintain confidence in the financial system.

The financial system continued to be affected by the banks' de-risking decisions which have resulted in the closing of some of the foreign exchange dealers' accounts due to elevated money laundering & terrorist financing risks associated with foreign exchange dealers. The Reserve Bank continues to work together with the authorized restricted foreign exchange dealers to strengthen their Anti-Money Laundering/Counter Terrorist Financing (AML/CFT) compliance status in order for the banks to retain their accounts. Furthermore, the Reserve Bank continues to liaise with the banks to encourage them to offer alternative products for de-risking with the aim of maintaining or reducing the cost of remittances to Tonga.

Financial Inclusion Initiatives

The global concept of financial inclusion is basically drawing the unbanked population into the formal financial system so that they have the opportunity to access affordable and appropriate financial products and services such as savings, credits, and insurance. The Reserve Bank continued to drive the financial inclusion initiatives in Tonga for the benefits of improving individual welfare, poverty alleviation as well as economic growth. The development of the Micro, Small and Medium Enterprises (MSMEs) sector and their access to finance is one of the initiatives of promoting financial inclusion in Tonga. The Reserve Bank hosted a MSMEs workshop in November 2016 with the objectives to identify the challenges faced by MSMEs in accessing finance as well as to develop strategies to address those challenges. In addition, the Reserve Bank conducted a one-on-one stakeholder consultation with more than 10 stakeholders in raising awareness of the MSMEs working group that is about to be established soon. It is essential that the development of the MSMEs sector is aligned with the vision of the Tonga Strategic Development Framework (TSDF) 2015 – 2025 as it will contribute to Tonga's economic growth to be more inclusive and sustainable as well as creating greater opportunities for the community to benefit from. Inclusive economic growth also supported the Reserve Bank's main objectives of supporting macroeconomic stability and economic growth along with promoting a sound and efficient financial system. The developing of the MSMEs sector will come under the umbrella of the National Financial Inclusion Strategy.

The Reserve Bank in partnership with the Pacific Financial Inclusion Programme (PFIP) conducted an extensive consultation early this year, with government agencies, the private sector, financial service providers and non-profit organizations as a lead up to the development of Tonga's first National Financial Inclusion Strategy. The consultations were to raise awareness on the strategy's focus for the delivery of financial services at affordable costs to sections of disadvantaged and low-income segments of society and the importance of financial literacy and consumer protection for all Tongans. The PFIP provides technical support to the Reserve Bank who will be leading the compilation of the strategy and coordinating financial inclusion activities. The developing the National Financial Inclusion Strategy is currently done by Reserve Bank where the strategy is based on the outcomes of the Demand Side Survey (DSS), the Supply Side Survey (SSS) and the consultations stated above. The strategy is intended be used to create an enabling policy environment for the provision of financial services to the low-income segments of society and to actively promote both the demand for and the supply of financial services to the unbanked both directly and indirectly. The strategy is aligned to the Tongan Strategic Development Framework (2015-2025), focusing on strengthening Tonga's economic institutions through an enabling business environment supported by a robust, inclusive financial system, and more effective public/private partnerships.

Furthermore, in pursuance of promoting financial inclusion and to address concerns raised from the Legislative Assembly and the public on high interest rates and unfair treatment of customers, the Reserve Bank continues with its initiatives to provide further protection to the consumers as follows, most of which are included in the legislative amendments that are being processed:

- ✓ Introduction of laws and regulations for non-bank financial institutions;
- ✓ Introduction of a financial consumer protection policy;
- ✓ Imposing of requirements to improve the transparency and disclosure to customers of the interest rates and fees on their loans;
- ✓ Developing policies to provide a code of conduct for the handling of mortgage arrears and the loan recovery process;
- ✓ Enhancement of consumers' financial literacy through financial inclusion programs and more transparent reporting and disclosure from all financial institutions.

6. Fiscal Indicators

Over the 6 months to February 2017, the fiscal position remained positive. This is in line with the IMF findings in its Staff Visit in March 2017, which highlighted that the government spending in 2016 was lower than expected driven by the postponement of maintenance works and a smaller increase in public servants' salaries. Banking system data shows the net credit to government declined by $28.6 million (43.2%) over the 6 months to February 2017, compared to a $17.7 million (36.7%) fall in the 6 months to August 2016. This stemmed from rising government deposits during the past 6 months to February 2017. The receipt of the budgetary support, grant funds and dividends from public enterprises supported the growth in government revenue during the past 6 months.

Moreover, the amended custom duties and excise taxes which became effective on the 1st July 2016 may have contributed to the higher revenue over the past 6 months. Revenue collected from custom duties and excise tax reached another record high in December 2016, supported a strong growth in the economic activities. This resulted in more imports, the increase in the number of containers by 394 registrations (7.7%) and the rise in vehicle registrations by 245 vehicles (14.7%) over the past 6 months.

In year ended terms, net credit to government also decreased by $46.3 (95.7%), owing to a $47.9 million (66.0%) increase in government deposits. The receipt of budgetary support before the end of the 2015/16 financial year largely contributed to this increase. Additionally, government bonds issued during the year has resulted in a $1.7 million (6.8%) increase in the banks' holdings of government bonds contributing to higher credit to government but was partially offset by the rise in government deposits.

The 2016/17 government budget anticipated the receipt of $30.4 million in budget support from development partners, however, none has been received to date. Nevertheless, a delayed budgetary support of $6.1 million from the European Union (EU) that was budgeted for 2015/16 was received in October 2016. This contributed to the higher foreign reserves over the past 6 months to February 2017. The budget support funds estimated for 2016/17 is expected to be received before the end of the 2016/17 financial year.

Tonga maintained its moderate debt distress rating, despite the 50% of the grants received from World Bank and Asian Development Bank during the year being deemed credit. The projected total public debt position for June 2017 represented 50% of GDP, of which 44% is external debt and 6% is domestic debt. This is consistent with one of the three fiscal targets in the Government of Tonga Fiscal Strategy for 2017/18, which is to maintain the external debt below 50% of GDP. The other two targets are to raise domestic revenue collections to at least 22% of GDP and to maintain the compensation of employees at no more than 53% of domestic revenues and moving towards 50% over time. The estimated total debt service for 2016/17 is to remain at over $20 million where majority of this debt service is to finance the external loan repayments. External debt service is projected by the Reserve Bank to remain at over $10 million for the next fiscal year, and then rise significantly to over $25.0 million in 2018/19 due to the first principal repayment for the Nuku'alofa Central Business District Reconstruction loan due in September 2018, followed by the commencement of principal repayment for the Tonga National Road Improvement Project loan in March 2020, both to EXIM Bank of China. The main repayment months for external debt are September and March of every year due to repayment of two major loans to EXIM Bank of China. The EXIM Bank of China remained the main external debt creditor hence the Chinese Renminbi has the highest share of the total external debt portfolio. This significant increase in external debt service to EXIM Bank of China in 2018/19 is anticipated to put pressure on the level of foreign reserves.

The Reserve Bank in its liaison program with the Ministry of Infrastructure and Tourism, indicated that the government has signed an implementation agreement of $55 million with the government of People's Republic of China for the construction of

Tonga High School Sports Complex. The sports complex preparatory works are scheduled for August 2017 with construction works expected to start in October 2017 and to be completed by May 2019. The upgrade of the Teufaiva Stadium is funded through a development initiative by the New Zealand government. Part one of the proposed works is expected to be completed in June 2017 and part two is anticipated to be completed in December 2017. These construction activities support the Reserve Bank's projection for continuous strong growth in the construction sector in the years to come.

On the outlook, the government receipts is expected to rise in the near term due to the budget support that are yet to be received in 2016/17 financial year. This would contribute to the Reserve Bank's projection for foreign reserves to remain at comfortable levels to June 2018. Additionally, the imposing of the foreign exchange transaction levy and the implementation of amendments to the customs duty and excise tax and the anticipated strong economic activity may also contribute to the increase in government revenue collection.

Net credit to the government is also anticipated to decline as a result of expected government budgetary support and grants receipts. However, this will be partially offset by the projected expenditure in the government's 2017/18 budget statement, which is due to be released in June 2017. The Reserve Bank will closely monitor the implication of the fiscal policy measures on the monetary policy objectives.

7. Monetary Policy Stance

The Reserve Bank maintained its current monetary policy stance. Despite the significant increase in the annual inflation rate in February 2017, the foreign reserves remained at comfortable levels above the minimum range of 3 – 4 months of import cover, exchange rates were competitive, the banking system remained sound with strong capital and liquidity position maintained and the domestic economy experienced favorable growth as projected.

The Reserve Bank's outlook for strong domestic economic activity remains in the medium term. The level of foreign reserves is also expected to remain at comfortable levels supported by expected higher receipts of remittances and foreign aid and this will be partially offset by the projected rise in imports.

The annual headline inflation rate is anticipated to fall below the Reserve Bank's inflation reference rate of 5% per annum in August 2017. It is also projected that the foreign reserves will remain comfortably above the minimum range of 3 – 4 months of import cover. The stability of the financial system was maintained with no signs of overheating despite the strong credit growth over the year.

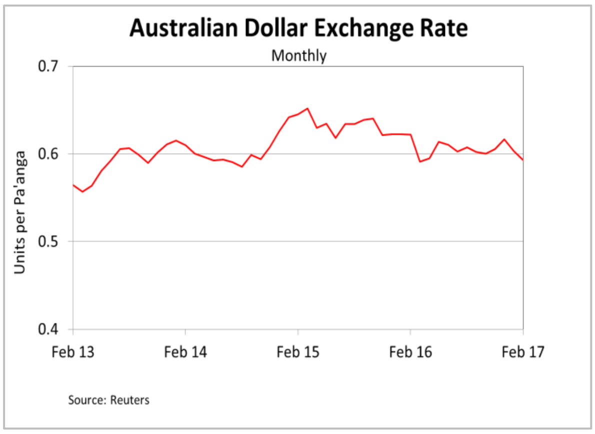
Excess liquidity in the banking system still remained as the continuous increase in deposits, coinciding with the higher foreign reserves, outweighed the strong credit growth. The banks' loans/deposit ratio remained below the 80% loan to deposit target. The excess liquidity in the system therefore continues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

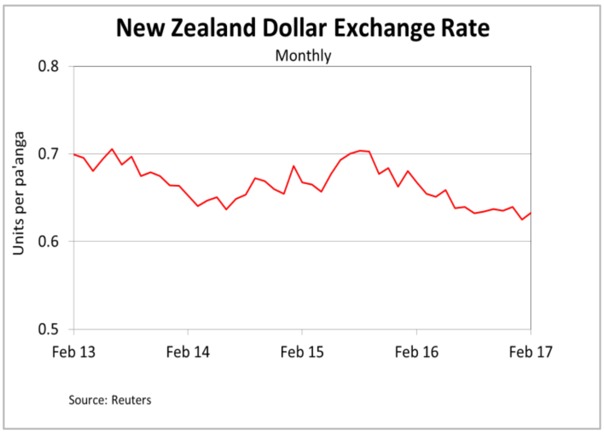
Given the recent developments and the outlook on the monetary policy targets, the current monetary policy stance is considered appropriate in the medium term. Therefore, the Reserve Bank will continue to adopt measures, as outlined below, to encourage the utilisation of the excess liquidity in the banking system to increase lending in order to support domestic economic growth, and strengthen the monetary policy transmission mechanism in the medium term.

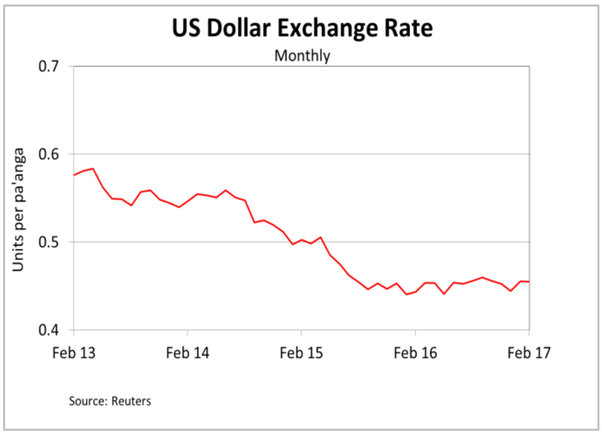
- ✓ Maintain the monetary policy rate (interest rate on banks' exchange settlement accounts or excess reserves) at 0% (zero interest rate policy);
- ✓ Maintain the minimum loans/deposit ratio at 80% to be achieved by June 2017, 85% by December 2017 and 90% by June 2018;
- ✓ Increase the Statutory Reserve Deposit ratio from 5% to 10% effective in July 2017;
- ✓ Maintain the inflation reference rate at 5%;
- ✓ Continue to closely monitor the effects of the eased Foreign Exchange Control requirements and economic development on the foreign reserves;
- ✓ Consider using open market operation (such as the issuance of NRBT notes) to mop up the excess liquidity in the system;
- ✓ Develop the domestic market in order to be more market based and efficient in the issuing of securities, which would in turn provide local investment opportunities and avoid pressure on the foreign reserves through outgoing capital investments;
- ✓ Continue with the financial inclusion initiatives to improve access to financial services and provide further protection to the consumers through the regulation of non-bank financial institutions, introduction of a financial consumer protection policy, and enhancement of consumers' financial literacy.

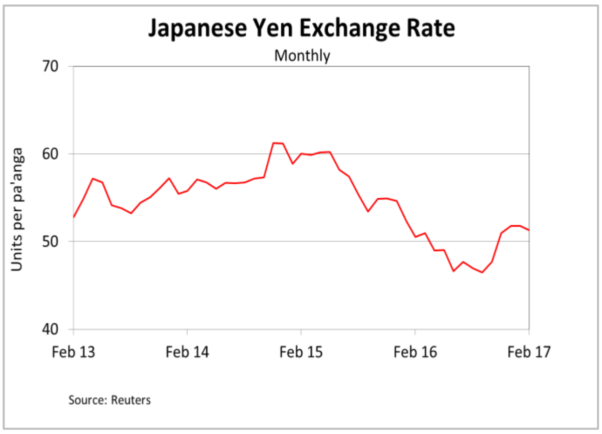
The Reserve Bank will remain vigilant and continue to closely monitor early signs of vulnerability, developments in the domestic and global economy, and update its monetary policy setting to maintain internal and external monetary stability, and to promote a sound and efficient financial system in order to support macroeconomic stability and economic growth.

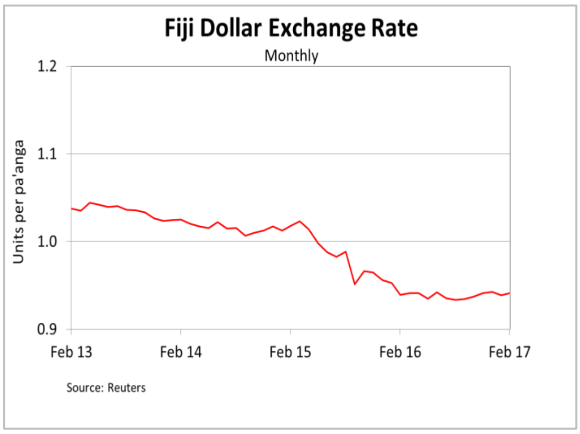
Appendix 1: Tongan Pa'anga Exchange Rates

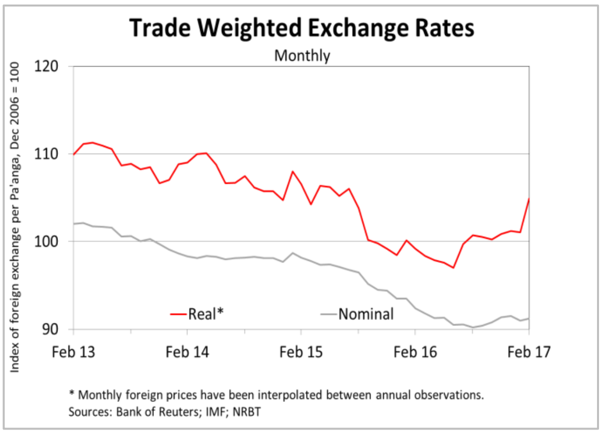












Appendix 2: Monetary Policy Objectives

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

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

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

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

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

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

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

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

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

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