NATIONAL RESERVE BANK OF TONGA

Monetary Policy Statement

February 2019

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List of abbreviations

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

Overview

Recent Development

Throughout the last six months to February 2019, the Reserve Bank maintained its current accommodative monetary policy stance. This supported meeting the monetary policy objectives by ensuring an adequate level of foreign reserves was maintained above 3 months of import cover, and the exchange rate remained competitive. Inflationary pressure eased as the inflation rate fell below the reference rate of 5% per annum in February 2019. Financial stability was maintained with no signs of overheating, despite the strong credit growth over the year, while excess liquidity still remains in the banking system.

Preliminary figures released from the Tonga Statistics Department shows Real GDP growth of 0.2% for 2017/18 following very strong growth of 5.4% in 2016/17. This is lower than the 3.1% forecasted by the Reserve Bank, but was close to the IMF's forecast 0.1%. The slow down in 2017/18 was mainly driven by negative growths in the construction, fisheries, and utility sector. Other sectors recorded slower growth compared to the previous year except for the Mining & Quarrying sector, and the Ownership of dwellings.

The annual headline inflation has returned below the Reserve Bank's reference rate of 5% since December 2018. In February 2019 it has declined further to 3.2% mostly driven by lower import prices of food products and oil. On the other hand, domestic prices increased by 8.5% over the year due to rising prices of local food items and tobacco. However, this was offset by the decline in import prices.

Balance of the Overseas Exchange Transactions (OET) was at a $1.5 million deficit, over the six months to February 2019, compared to a $27.0 million surplus in the six months to August 2018. This deficit is underpinned by the widening of the current account deficit due to growing import payments and lower transfer receipts. Consequently, the official foreign reserves declined to $473.5 million in February 2019 from $475.0 million in August 2018.

The official foreign reserves were sufficient to cover 8.0 months of import of merchandise goods and services[1] in February 2019, which is still above the Reserve Bank's minimum level of 3 months of imports cover. In year ended terms, gross official foreign reserves rose by $25.5 million, corresponding to higher receipts of remittance, foreign aid from donor partners and budgetary support for the Government. The Reserve Bank implemented the Foreign Exchange Control Act which came into effect in November 2018 and issued its Exchange Control Directive to improve it's ability to better manage, and to maintain an adequate level of foreign reserves.

The banking system continued to remain sound supported by strong capital position, adequate profitability, high liquidity, and low levels of non-performing loans. Over the six months to February 2019, the total banks' lending continued to rise to a new record high, whereas deposits slightly declined. The expansion in lending was mainly for businesses in the transport, wholesale & retail, manufacturing and construction sectors. This reflected growth in the private sector, business confidence and on-going construction of infrastructure projects. The weighted average interest rate spread also widened as lending rates increase while deposit rates declined.

Liquidity in the banking system (reserve money) has declined to $320.6 million in February 2019 after reaching a record high of $334.2 million in August 2018. This is attributed mostly to lower deposits by the commercial banks to the Reserve Banks vault coupled with the lower currency in circulation. The Reserve Bank maintained its policy rate at 0%, and the Statutory Reserves Deposit Ratio at 10%, while encouraging commercial banks to utilize the excess liquidity for further lending. Broad Money also fell to $589.0 million as a result of lower net foreign assets and net domestic assets. The lower net foreign assets over the past 6 months is in line with the decline in foreign reserves, whereas decreasing net credit to Government led to the lower net domestic asset. Meanwhile, banks' total loans to deposit ratio continued to edge up to 76% but still remained below the 80% minimum loan to deposit ratio,

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

indicating there is still capacity for further lending by the banks to further support economic growth.

Government deposits rose by 14.3% over the past six months to February 2019, resulting in the lower net credit to Government. Higher government revenue collection combined with receipts of budgetary support, grants, and cyclone relief funds from development partners supported the higher government deposits.

Outlook

Due to the delays in the implementation of major Government projects and the updated statistics received during the past six months, the Reserve Bank has revised its previous forecast of 4.5% Real GDP growth for the year 2018/19, down to 3.4%. The anticipated growth is supported by projected growths from various sectors such as the agricultural, construction, trade, utilities, mining & quarrying, transport & communication, and ownership of dwellings sector. The impact of TC Gita on the primary sector is expected to wear off towards the end of the financial year, whereas construction and infrastructural projects are expected to boost the secondary sector. Active trading and further development to the transport and tourism sector are also expected to strengthen the tertiary sector.

As previously anticipated, the inflation rate has fallen below the Reserve Bank's reference rate of 5% in 2019, and it is expected to remain below the reference rate for the remainder of 2019. Nevertheless, Tonga's vulnerability to natural disasters and the developments in global food and oil prices pose a risk to this expectation. The Reserve Bank will closely monitor the sources of higher inflation, which include assessing the impact of the rate of exchange of the paánga against the other currencies, and new Government tax introduced.

Despite the slight decline in the level of foreign reserves, the Reserve Bank still expect it to remain at comfortable levels well above the minimum of 3 months of imports by the end of 2018/19. This forecast is supported by expected receipts of budgetary support and grant funds from development partners and expected higher receipts of remittances. This will be partially offset by the projected rise in imports and public debt repayment overseas.

The Reserve Bank still projects a credit growth of 13% for 2018/19. Seasonal festivals and cultural obligations, coupled with the ongoing business investments will increase demand for credit and continue to support credit growth. The excess liquidity in the banking system still remains indicating available capacity for further lending by banks. The Reserve Bank will continue to remain vigilant and closely monitor the credit growth and broad money movements for any early signs of overheating in the economy. Non-performing loans are also expected to remain at low levels.

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

Given the recent developments and the outlook on the monetary policy targets, the Reserve Bank considers its current accommodative monetary policy stance to be appropriate in the medium term. Therefore, the Reserve Bank will maintain its current monetary policy measures in the medium term in order to encourage the utilisation of the excess liquidity in the banking system to increase lending, particularly to the growth sectors, in order to support domestic economic growth, the recovery from TC Gita, and strengthen the monetary policy transmission mechanism. Furthermore, the Reserve Bank will continue to monitor developments in the domestic and global economy closely, and update its monetary policy setting to maintain internal and external monetary stability and to promote a sound and efficient financial system that supports macroeconomic stability and economic growth.

Sione Ngongo Kioa

Governor

1. Global Developments

World Growth

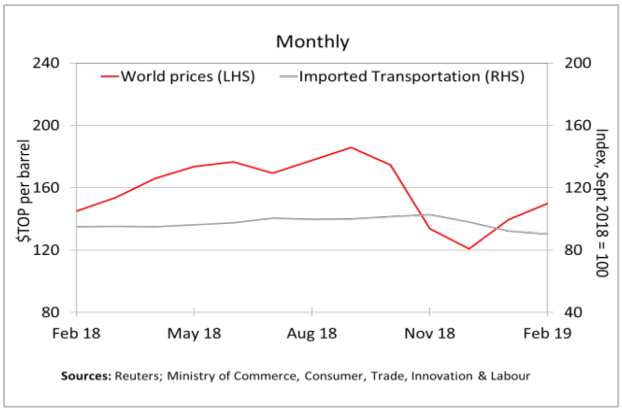
The IMF released its 2019 World Economic Outlook (WEO) in April, which showed that global economic growth has continued to slow down. This stems from the escalated trade tensions between the US and China, economic crises in countries such as Argentina and Turkey, and tightening credit policies in Asia (specifically China). These developments have carried on into 2019 from late 2018. Furthermore, this has resulted in global growth being revised downwards to 3.3% in 2019 (compared to the forecast of 3.7% in the IMF October 2018 WEO). This follows a growth of 3.6% recorded for the year 2018.

In advanced economies, growth is expected to continue slowing at a steady pace due to the impact of the fading US fiscal stimulus, aging trends, and low productivity growth. Commodity prices have been volatile recently reflecting supply influences relative to a backdrop of softened demand. However, according to the IMF's Primary Commodity Prices Index, commodity prices declined by 10.8% over the 6 months to February 2019. This was a result of lower energy prices (particularly oil prices). Oil prices fell to their lowest point during the past six months since the second half of 2017.

World Oil Prices

According to Reuters, world oil prices averaged around US$64.19 per barrel in February 2019. This is considerably lower compared to USD$73.76 per barrel in August 2018. This is also lower than an average of US$66.54 per barrel a year ago.

Figure 1: World Oil prices



The IMF April 2019 WEO states that oil prices are expected to average at US$59.2 in 2019 and US$59.0 in 2020 (lower than the October 2018 WEO respective prices of US$68.8 and US$65.7). Oil prices are further projected to remain within this range and to reach USD$60 per barrel in 2023. This forecast for 2023 remains unchanged compared to the October 2018 WEO. These forecasts are based on recent subdued demand expected for the medium-term as well as production adjustments by suppliers in the aim to avoid large excess supply.

Furthermore, oil prices have been highly volatile during the past six months. In September 2018, oil prices surpassed US$80 (the highest level since 2014). However, US crude oil production averaged 10.9 million barrels a day (mbd) in 2018, which actually increased by 1.6 mbd over the past year. This exceeded expectations, which led to a sharp fall in oil prices during the past six months. Additionally, Canada, Iraq, Russia, and Saudi Arabia also produced at high levels. As such, lower oil prices are expected for 2019 and 2020.

Advanced Economies

The IMF February 2019 WEO lowered its projections for advanced economies such as the US which experienced softer economic activity as a consequence of the increase in trade tensions and tariff hikes with China. This has also resulted in dampening business confidence, tightening of financial conditions, and higher policy uncertainty across many economies. As such, the US GDP growth projections was revised downwards for 2019 to 2.3% from 2.5% presented in the last IMF WEO in October 2018. This reflects the impact of the partial US government shutdown, and lower than expected fiscal spending. Economic growth for 2018 is still expected to record 2.9%, however, it is expected to slow to 1.9% in 2020. Unemployment rates in the US have improved to 3.8% in February 2019 compared to 4.0% in January 2019 and 4.1% in February 2018, and is further projected to continue this trend for the remainder of 2019 and for 2020. US consumer prices recorded at 2.4% in 2018 as expected and inline with the IMF October 2018 WEO, whilst inflation for 2019 was slightly revised downwards from 2.1% to 2.0%.

Furthermore, inflation is expected to rise to 2.7% in 2020. The US federal funds rate is expected to increase to about 2.75 percent by the end of 2019.

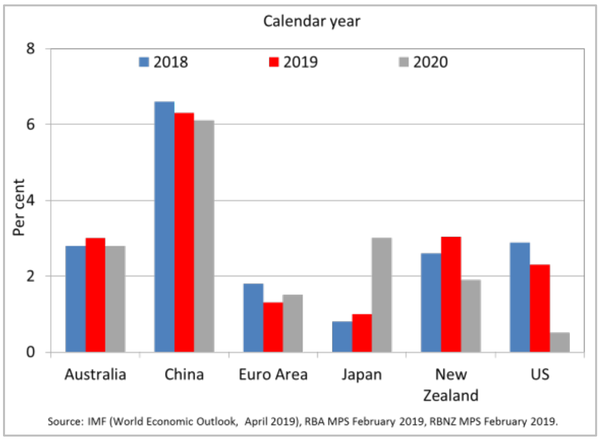
The Reserve Bank of Australia (RBA) reported in its February 2019 MPS that the Reserve Bank Board continued to maintain the cash rate at 1.5% which is unchanged since August 2016. This is on the back of the Australian economy's most recent performance which eased according to their latest data available and recording a 2.8% growth (year to September 2018). This growth was supported by low-interest rates and moderating global growth. GDP is estimated to reach 3.0% in 2019 and moderate to 2.8% in 2020 (revised downward from 3.3% for 2019 in RBA's August 2018 MPS). This is supported by the accommodative monetary policy and tighter labour market conditions. As for inflation, headline figure recorded at 1.8% over the year to December 2018, which is in line with the expectations published in the August 2018 MPS. This resulted from the gradual rise in wages. Inflation is forecasted to remain unchanged at 1.8% in 2019 before rising to 2.3% in 2020. This is due to projected lower fuel prices for 2019, whereas tobacco excise increases will hold out until 2020.

The Reserve Bank of New Zealand (RBNZ) reported in its February 2019 MPS that the official cash rate (OCR) remained unchanged at 1.75% on the back of inflation remaining below the Reserve Bank's target mid-point and economic growth being supported by job creation. The MPS also referred to the need for low-interest rates in order to support economic growth and inflation, which may likely alter the OCR in the near future. The latest GDP data for 2018 recorded a growth of 2.6% due to the high demand for labour and improvement in unemployment rates. However, GDP is forecasted to grow by 3.0% in 2019 and 2020 (compared to 2.6% and 3.4% forecast in the previous RBNZ MPS). The upward revision for GDP growth in 2019 stems from the expected increase in government spending whilst the downward revision for GDP growth in 2020 resulted from an expected decline in labour growth and thus productivity. The annual headline inflation data for December 2018 was below the Reserve Bank target mid-point of 2.0%. at 1.9%. This was due to a tightening in the labour market partially outweighed by the recent decline in petrol prices. Inflation is projected to record a 1.4% and 2.0% (as domestic inflationary pressures rise) increase for 2019 and 2020 respectively. However, inflation will still remain within the RBNZ's target range of 1-3%.

The United Kingdom (UK) was reported by the IMF WEO April 2019 to have recorded a growth of 1.4% in 2018 as projected in the previous WEO. However, growth for 2019 was revised downwards to 1.2% (from 1.5% in the previous WEO) driven by heightened uncertainty reflecting prolonged negative effects about the Brexit outcome. However, for 2020, GDP is expected to grow by 1.4% and to be backed partially by the positive impact from the fiscal stimulus that was announced in the 2019 budget. Headline inflation recorded a 2.5% rise in 2018 as forecasted in the previous WEO. The headline inflation is expected to decline to 1.8% (from previously forecasted 2.2%) in 2019 due to falling energy prices. However, headline inflation is still expected to edge up to 2.0% in 2020. The uncertainty regarding Brexit negotiations may require monetary policy to be adjusted as well as fiscal consolidation, if growth slows substantially.

Growth in the Euro Area was 1.8% in 2018 and expected to moderate to 1.3% in 2019 (from previous forecasts of 2.0% and 1.9% respectively in IMF October 2018 WEO). The downward revision to growth resulted from the soft growth in countries such as Germany and Italy. This soft growth was caused by the slowing private consumption and domestic demand. France also experienced weaker than expected growth as a result of negative impacts stemming from street protests. Headline inflation in 2018 was 1.8% (close to the projected 1.7% in previous WEO) and is expected to decline to 1.3% in 2019 on lower energy prices before increasing to 1.6% in 2020. Again, the lower energy prices are expected to lower headline inflation in 2019 whilst the economy is projected to operate above potential will put upward pressure on inflation in 2020. However, monetary policy should continue to remain accommodative across the Euro Area.

Figure 2: Growth Projection in the Advanced Economies



China's GDP growth was 6.6% in 2018 as previously forecasted yet it is expected to ease to 6.3% in 2019 (compared to 6.2% in previous WEO) and moderate further to 6.1% in 2020. The revisions to growth are driven by the regulatory tightening to the banking system in China as well as the increase in trade tensions with the United States. Headline inflation was 2.1% in 2018 close to 2.2% that was projected in the previous WEO. Furthermore, inflation is expected to rise further to 2.3% in 2019 and 2.5% in 2020, driven by the impact of trade tensions on China's prices. In the meantime, inflation will continue to remain below the Government's target to hold the CPI at around 3.0%, and the monetary policy stance is expected to remain unchanged.

Japan's economy weakened, particularly in the third quarter of 2018 due to natural disasters. As such, GDP growth was at 0.8% in 2018 compared to 1.1% projection in the previous WEO. However, GDP was slightly revised upwards for 2019 to 1.0% (from 0.9% previously projected). The slight revision mainly reflects additional fiscal support expected to roll out this year. In 2020, GDP is expected to moderate and grow by 0.5% due to measures expected to mitigate the effects of a planned consumption tax increase for October 2019. Headline inflation increased by 1.0% in 2018, slightly below the forecasted 1.2% in the previous WEO. However, inflation is expected to rise slightly to 1.1% in 2019 before increasing by 1.5% in 2020, reflecting the expected impact on prices by the increase in consumption tax. In the medium term, inflation is still anticipated to remain below the Bank of Japan's target of 2.0%.

South Pacific Economies

The South Pacific region performed almost as expected, recording average GDP growth of 2.0% for 2018 (compared to the forecasted 2.3% by WEO in the last MPS). This reflects varying economic activity amongst the island economies such as Papua New Guinea (PNG) who experienced weaker growth due to lower production of Liquefied Natural Gas (LNG), crude oil, and gold, the impact and economic spillovers from the earthquake. On the other hand, Vanuatu recorded high growth due to a pick up in growth in the infrastructure, construction, and tourism sector. In Samoa, growth slowed further towards the end of 2017/18 driven by reductions in the output of the Fishing, Agriculture, and Financial Services sectors. Fiji's recent economic performance was strong and driven by consumption and investment with support from macroeconomic policies. As for inflation, the region recorded an average of 4.2% due mainly to influences of international prices. On the outlook, growth is expected to remain moderate and inflation may continue to decline due to the falling global oil prices.

Figure 3: Growth Projections in the Pacific

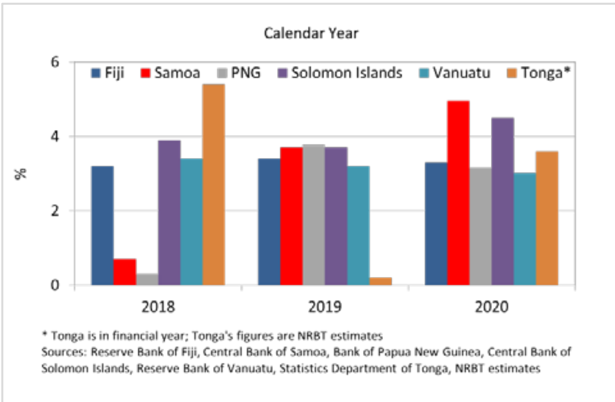


Table 1: World Data (Real GDP Growth, Inflation, and Unemployment)

	Real GDP growth (%)			Inflation (%)			Unemployment* (%)		
	2018	2019f	2020f	2018	2019f	2020f	2018	2019f	2020f
World Growth	3.6	3.3	3.6						
Australia	2.8	3.0	2.8	1.8	1.8	2.3	5.0	5.0	5.0
China	6.6	6.3	6.1	2.1	2.3	2.5	3.8	3.8	3.8
Euro Area	1.8	1.3	1.5	1.8	1.3	1.6	8.2	8.0	7.7
Japan	0.8	1.0	0.5	1.0	1.1	1.5	2.4	2.4	2.4
New Zealand	2.6	3.0	3.0	1.9	1.4	2.0	4.3	4.4	4.4
United Kingdom	1.4	1.2	1.4	2.5	1.8	2.0	4.1	4.2	4.4
United States	2.9	2.3	1.9	2.4	2.0	2.7	3.9	3.8	3.7

Note: f – forecast
Source: IMF (World Economic Outlook, April 2019), NRBT , RBA Feb 2019 MPS, RBNZ Feb 2019 MPS

2. Tonga's Economic Growth

Real GDP Growth

The Statistics Department in its National Accounts Statistics Report 2017-18 released the provisional figure for Real GDP growth 2017/18 to be 0.2%. This follows 4 years of progressive growths since 2013/14 peaking at 5.4% in 2016/17. The Statistics Department also revised up Real GDP growth for 2014/15, from 2.9% to 3.1%, 2015/16 from 4.2% to 4.8%, and 2016/17 from 5.0% to 5.4%. Revisions were due to updated data received by the Statistics Department. The average real growth rate for the past 10 years is now at 2.2%.

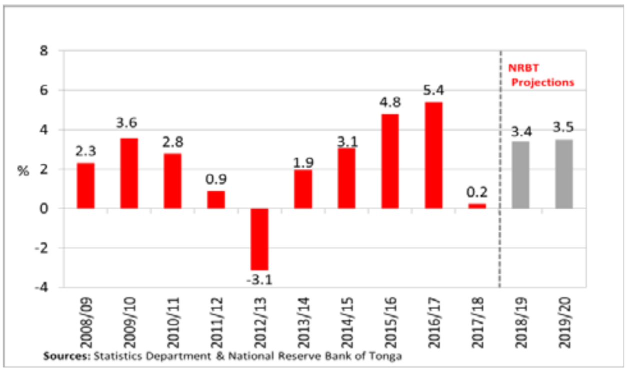
The upward revision to growth in 2014/15 was due to growth in the mining & quarrying sector, whilst the revision in the year 2015/16 was supported by growth in the construction and transport & communications sectors. The revision to the 2016/17 growth was largely driven by growth in the transport & communications sector.

Despite the devastation from TC Gita in February 2018, 0.2% growth was still recorded in 2017/18 and was attributed mostly to the growth in mining & quarrying, wholesale & retail trade, transport & communications, trade, financial intermediation, and public administration services sectors. However, this is considerably lower than the 5.4% growth in the previous year. This slowed growth was due to the negative growth recorded in the construction and fisheries sectors, followed by minimal declines in utilities, tourism, and education sectors. The construction sector recorded a negative growth following high growths in 2015/16 and 2016/17 of 20.6% and 16.0%, respectively. Majority of the construction projects such as the St. George Palace and Taufa'ahau Tupou IV wharf were completed within these years with just minimal work remaining in 2017/18. Moreover, disruptions to production by TC Gita to the fisheries and utility sector resulted in lower exports and electricity production, respectively.

In the August 2018 MPS the Reserve Bank had forecasted a much higher growth of 3.1% for 2017/18 based on the expected post-TC Gita rehabilitation works which would have supported consumption and investment, offsetting the expected contractions in the fisheries and utility sectors. However, delays to the implementation of reconstruction works for TC Gita rehabilitation resulted in an overestimated growth in the construction sector of 10% compared to the negative 11.8% reported by the Statistics Department.

On the outlook, the Reserve Bank still expects stronger growth for 2018/19 of 3.4%, slightly lower than the previous forecast of 4.5% in August 2018 MPS. We expect a rebound in all the sectors from their performance in 2017/18, although not as high as previously forecasted, specifically in the agriculture, fishing, construction, mining & quarrying, and the tourism sectors. Few major Government infrastructure projects and some of the delayed reconstruction work for the recovery from TC Gita were completed in 2018/19, thus supporting the stronger projected growth of 3.4% compared to 0.2% in 2017/18. These include the reconstruction of schools and residential buildings. Government has issued more than $19 million as a recovery response-related to TC Gita, for the reconstruction of residential and government offices and buildings.

Figure 4: Real GDP Growth



Furthermore, delays in the reconstruction works and implementation of other projects planned for 2018/19 will contribute to the growth in subsequent years, together with some new Government projects already in the pipeline. Better performance is also projected for the agricultural and fisheries sectors as they fully recover from the impact of TC Gita. As such, the forecasted growth for 2019/20 remains unchanged at 3.5%.

	Revised Official 2015/16	Revised Official 2016/17	Preliminary 2017/18	FY 2018/19 (Aug-18 MPS) %	FY 2018/19 (Revised)%	FY 2019/20 (Aug-18 MPS) %	FY 2019/20 (Revised)%
GDP	4.8	5.4[2]	0.2	4.5	3.4	3.5	3.5
Primary production	0.5	1.3	-1.0	1.9	0.6	1.6	2.1
Agriculture	-0.4	1.6	0.6	2.0	0.5	1.5	2.0
Forestry	-20.2	-0.6	0.0	1.0	1.0	0.5	0.5
Fishing	8.9	-0.1	-9.3	2.0	1.0	2.0	3.0
Secondary production	9.5	10.8	-5.8	10.0	7.6	7.2	4.4
Mining and quarrying	-33.8	16.5	8.6	6.0	6.0	5.0	8.0
Manufacturing	1.3	3.8	0.2	3.0	2.0	3.0	4.0
Utilities	9.2	8.1	-0.3	7.0	8.0	5.0	5.0
Construction	20.6	16.0	-11.8	15.0	11.0	10.0	10.0
Tertiary production	5.7	4.0	2.7	3.1	3.2	2.8	2.9
Trade	10.6	10.4	4.2	4.0	4.0	4.0	4.0
Hotels, restaurants	7.2	3.7	-0.2	2.0	1.0	2.0	2.0
Transport, communication	8.3	8.9	7.0	4.1	4.5	4.0	5.0
Financial intermediation	12.6	1.5	3.9	7.0	7.0	5.0	5.0
Real estate, business services	6.7	8.1	-1.6	2.0	2.0	2.0	2.0
Public administration	0.4	-1.7	2.8	1.0	1.0	1.0	1.0
Education	-3.1	8.2	-1.3	2.0	2.0	2.0	2.0
Health and social work	8.6	0.0	0.0	1.5	1.5	1.5	3.0
Recreational, cultural activities	5.1	0.0	0.0	2.0	2.0	2.0	2.0
Other community services	19.5	2.2	-1.5	1.5	1.5	1.5	1.5
Ownership of dwellings	0.1	0.6	0.6	3.0	3.0	2.0	2.0
Other*	7.7	8.4	0.0	1.0	1.0	1.0	1.0

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

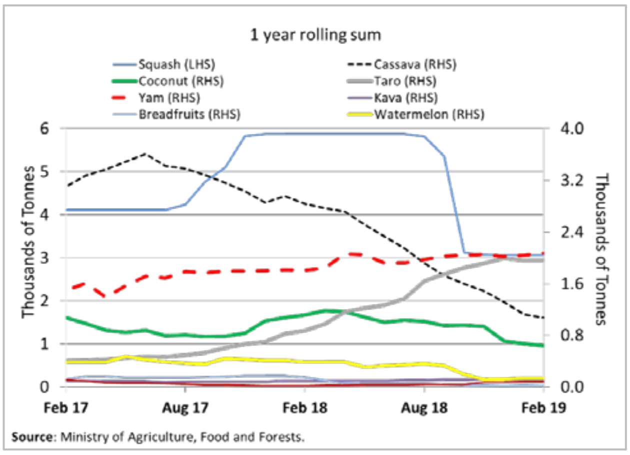
[2] Real GDP growth for 2016/17 was revised upward from 4.2% whilst 2017/18 was also revised upward from 5.0% in respective financial years.

Primary Production

The primary sector recorded a negative growth of 1.0% in 2017/18 following a positive 1.3% growth in 2016/17. This was driven by a negative growth of 9.3% in the fisheries sector, which outweighed the positive 0.6% growth in the agricultural sector in 2017/18. The decrease in fishing is in line with adjustments made by the Statistics Department to the definition of foreign vessels catch to be reclassified as imports rather than domestic production. Few of the local fishing vessels suffered damages by TC Gita, which affected their fishing activities and production in 2018. However, both exported and locally sold agricultural produce increased throughout 2017/18.

The primary sector is expected to grow by 0.6% in 2018/19 (revised down from 1.9% in August 2018) due to the adverse effects of TC Gita on the yield/harvest throughout the remainder of 2018. During the first eight months of 2018/19, the total volume of agricultural exports decreased by 3,805.3 tonnes compared to the first eight months of 2017/18. This was due to lower squash and cassava exports by 2,810.2 tonnes and 1,254.2 tonnes, respectively. Coconut exports also decreased by 365.5 tonnes. The Reserve Bank's liaison program find farmers to be optimistic yet again towards the financial year 2018/19 but growth in exports is not expected to be as strong as previous years hence, the downward revision.

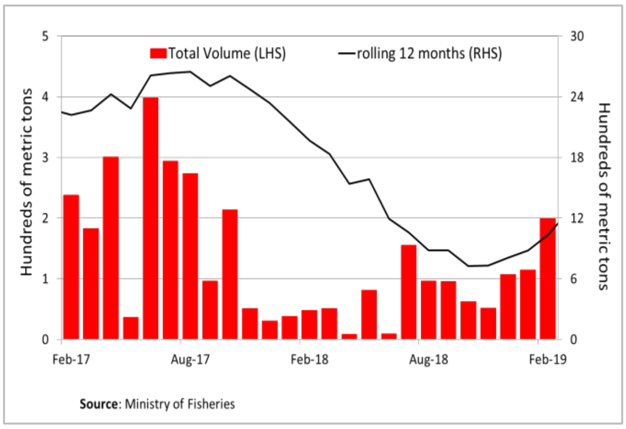
Figure 5: Major Agricultural Exports (tonnes)



Additionally, crops that were sold domestically also declined by 1,400.2 tonnes (40.8%) during the first eight months of 2018/19. Almost all crops available in the domestic agricultural market decreased led by watermelon, coconuts, cassava, and yam. However, the agricultural export proceeds slightly rose to $7.8 million in the first 8 months of 2018/19, $0.35 million higher than the same period in 2017/18. This increase in export receipts was supported by higher squash exports proceeds, despite the decline in volumes exported. Liaison with the squash industry suggests that the export price of squash in 2018 was favourable. Growth in the agricultural sector was further supported by the Government Development Loan scheme facilitated by the Tonga Development Bank and access to affordable loans by growers and agricultural exporters.

The agricultural sector is expected to grow in 2019/20, at a higher rate of 2.0%, (up from 1.5% previously forecasted). Better harvest is expected in the upcoming year, reflecting Government initiatives and donor-funded projects that are directed to this sector. However, the greatest risks to the outlook in the agriculture sector are the vulnerability to natural disasters and the sustainability of land after being farmed continuously.

Figure 6: Fish Exports (metric tons)



Following 2 years of negative growth in the fisheries sector, during the first 8 months of 2018/19, exports of aquarium products increased significantly by 86,095 pieces coinciding with a $1.2 million (29.8%) rise in proceeds from marine exports. Domestic sales data, reported by the Ministry of Fisheries, also suggest increased sales from fisheries in the first 6 months of 2018/19 by $0.1 million (27.5%) to a total of $0.5 million. On the other hand, the volume of marine exports (excluding aquarium products) declined by 162.1 tonnes (15.5%). This was due to a fall in the exports of tuna by 164.5 metric tons (18.1%).

The Reserve Bank, therefore projects 1.0% growth in the Fisheries sector in 2018/19 (down from 2.0% in August 2018). The projected growth is further supported by various initiatives and incentives from the Ministry of Fisheries to improve the sector, such as Tonga's Fisheries Sector Plan, and other on-going fishing activities by businesses and individuals. Donor-funded projects by the World Bank and the Chinese Government also supports the positive forecast. This sector continues to benefit from the duty exemptions on oil and fishing gears, together with the initiatives of the Fisheries Development and Export Fund (FDEF) by the Government through its GDL scheme to support access to finance of fishermen. Growth is expected to continue into 2019/20 by 3.0%. Nonetheless, weather uncertainties still remain a risk to this sector.

Stagnant growth was recorded for the forestry sector in 2017/18 following a negative 0.6% growth in 2016/17. It is anticipated that the network upgrade projects in Tongatapu and Vava'u by Tonga Power Ltd will contribute positively to this sector in the upcoming years. Hence, the growth forecasted for the forestry sector is unchanged at 1.0% for 2018/19, before reverting to slower growth of 0.5% in 2019/20.

Secondary Production

The industrial sector recorded a negative 5.8% growth in 2017/18, following high positive growth of 10.8% in 2016/17. Positive growth in previous years for the construction sector was the main driver of growth in industrial production. However, the negative 11.8% and 0.3% growth of the construction and utility sectors, respectively in 2017/18 led to the overall decline. Despite the contractions in the construction and utility sectors during 2017/18, the mining & quarrying, and manufacturing sectors recorded positive growth, although lower compared to 2016/17.

Forecasted growth for the industrial sector in 2018/19 is revised down to 7.6% (from 10% in the previous forecast) due to the delay in the implementation of donor-funded construction projects that were expected to be completed during the year. The demand for housing renovations and new constructions is expected to increase. However, this depends on individuals' financial capacity. Loans to construction businesses increased by 8.6% in the 8 months to February 2019, reflecting ongoing construction works, while new commitment loans also indicate prospective projects in the future.

The construction sector is projected to continue to grow by 10.0% in 2019/20 as a result of the new construction projects and TC Gita reconstruction works and other delayed projects from 2018/19. These include a Health Facility for the Vaini Tonga Prisons, the extension of Tonga Visitors Bureau, new TBC (Tonga Broadcasting Commission) Building, Kongakava Boutique Hotel, Fangaloto Bridge Project, and the reconstruction of some of the Government Primary Schools, to name a few. The projected growth in the construction sector is expected to have positive spillover effects on the mining and quarrying activities, manufacturing, utility, and other sectors of the economy.

The number of existing houses decreased due to the destruction caused by TC Gita, however, it would be partially offset by the new constructions that were completed during the financial year 2018/19. On the outlook for ownership of dwellings, the sector is projected to grow by 3.0% in both the current and upcoming fiscal year.

Developments in the mining & quarrying sector are expected to be in line with the vibrant growth projected for the construction sector with 6.0% in 2018/19 and 8.0% in 2019/20. Liaison with the quarry companies indicates that they anticipate growth in the current and future financial years supported by infrastructural works in both the transportation and construction sectors, including other demands by individuals.

The utility sector is also expected to grow by 8.0% in 2018/19 due to the continuation of the Tonga Village Upgrade Network Project, Nuku'alofa Network Upgrade, and new buildings/houses being constructed. This is also supported by the increase in electricity production and consumption by 3.6 million kW and 2.2 million kW respectively in the first 8 months of 2018/19. The number of electricity consumers also rose by 265 in the first 8 months on 2018/19. However, the movements in global oil prices may dampen growth in the utility sector.

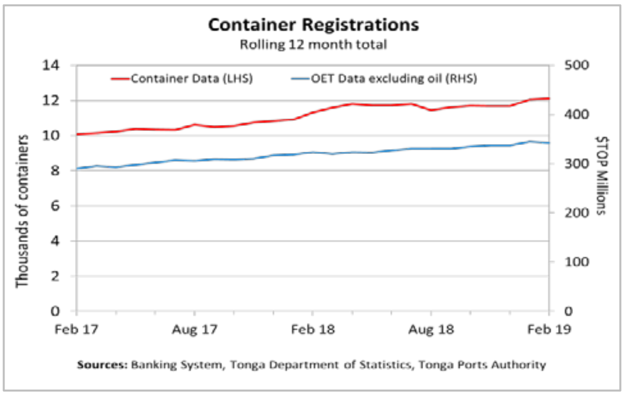
The manufacturing sector recorded a slow growth of 0.2% for 2017/18 in line with the slow down in construction. Meanwhile, a strong growth of 2.0% is projected for 2018/19 supported by higher demand for manufactured goods related to the completion of the anticipated constructions works. Additionally, the handicrafts production increased to 110.1 tonnes in the first 8 months of 2018/19 from 87.9 tonnes in 2017/18.

Tertiary Production

Very strong growth of 4.0% was recorded for the tertiary sector in 2016/17 (revised up from 3.4%) due to higher growth in the trade, communication and transportation sectors. In 2017/18, growth slowed to 2.7% as most sectors recorded slower growth in the services industry. Contractions were noted in the tourism, real estate & business services, education and community services sectors which may have suffered damages from TC Gita.

Slower growth of 4.2% was recorded in the trade sector for 2017/18 following a 10.4% growth in 2016/17 and 10.6% in 2015/16. During the first 8 months of 2018/19, container registrations increased by 1,637 containers (21.4%) compared to the first eight months of 2017/18. Both business and private containers rose by 35.8% and 4.4% respectively. In addition, imports of wholesale & retail goods payments also increased by $9.2 million (5.5%). The number of cargo ships during the same period also increased by 30 ships. Hence, the trade sector is expected to continue growing at 4.0% throughout 2018/19 and 2019/20. The celebrations and events held during the year, coupled with the increase in private consumption supports this expected growth.

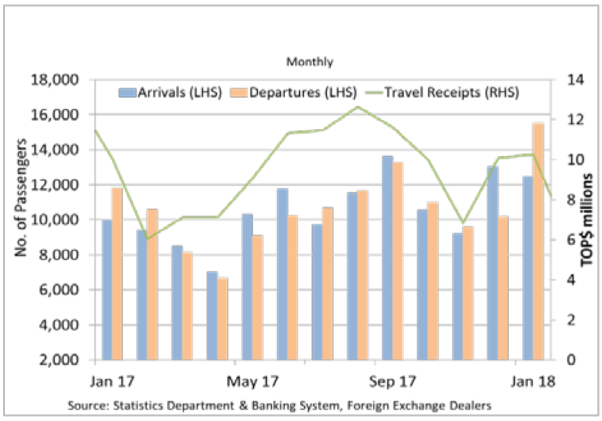
Figure 7: Import Indicators



The Reserve Bank expects imports and consequently container registrations to generally increase in the near term. Liaisons with the construction companies indicated growing demand in these sectors, which will also drive imports in the near future. Construction works are anticipated to contribute to the rise through spillover effects to the trade and tourism sectors.

In contrast to the negative 0.2% growth in 2017/18, the tourism sector growth is expected to rebound to 2.0% in 2018/19. During the first 8 months of 2018/19, international air arrival visitors rose by 2,614 passengers (3.6%) coinciding with a $9.6 million (12.1%) in travel receipts for the same period. Businesses in the tourism industry indicate in the liaison programs that they are expecting stronger growth in the current fiscal year and the next compared to the previous years, despite the closedown of the Scenic Hotel at Fuaámotu. This is supported by the popular whale watching season and other annual events held during the year such as the celebrations of His Majesty the King's 60th birthday, annual church conferences and the increase in the number of international flights and cruise ship arrivals. On that regard, the Reserve Bank maintains its 2.0% growth projected for the tourism sector in 2019/20.

Figure 8: International Air Arrivals & Travel Receipts



Growth in real terms for the financial intermediation sector was stronger at 3.9% in 2017/18 compared to 1.5% in 2016/17. This coincides with the growing number of loans as reflected in total banks' lending. This reflects the Reserve Bank's accommodative monetary policy stance to encourage the utilisation of excess liquidity in the banking system to support economic activities. However, the Reserve Bank expects lending to continue to increase in 2018/19 in line with expected growth in construction (particularly for households' loans) and other ongoing economic activities throughout the year, before slowing down in 2019/20.

Activities in the transportation & communication, real estate & business services, and recreational activities sectors are also expected to trend upwards and support the tertiary sector. The Reserve Bank projects growth for the tertiary sector in 2018/19 to remain at 3.2%, and then slow down to 2.9% in 2019/20.

Unemployment

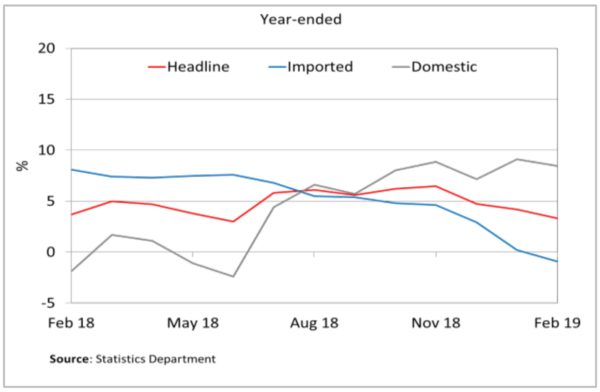
The unemployment rate remained unchanged at 16.4% as reported in the previous August MPS 2018. There have been no further changes or revisions to this figure by the Statistics Department. According to the Reserve Bank's survey of job advertisements in the first eight months of 2018/19, job advertisements rose by 64 advertisements, mostly in the public administration and business services sector indicating higher recruitment intentions. The Reserve Bank expects more demand for labour in the near term and thereby lower the unemployment rate.

3. Promoting Low and Stable Inflation

Recent Developments

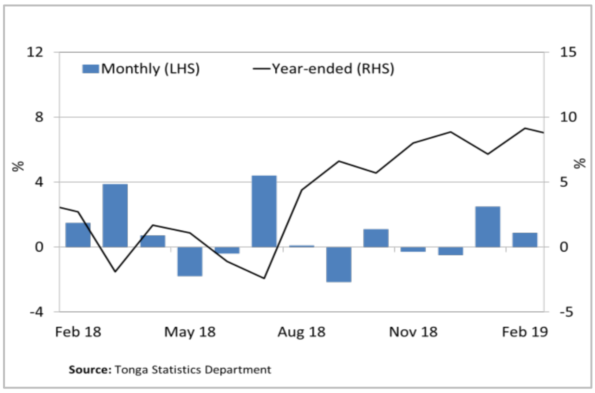
The Statistics Department has rebased its Consumer Price Index (CPI) recently, using the base period of September 2018 which is reflected in the October 2018 inflation data. CPI now covers price changes in Tongatapu and Vava'u, and the new weights were derived from the Household Income and Expenditure Survey (2015-2016). As such, the CPI figures for the previous months were also revised. Tonga's headline inflation fell below the Reserve Bank's 5% reference rate in December 2018, and has continued to decline further to 3.2% in February 2019. This was mainly due to a decline in the prices of imported food, fuel, and local communication.

Figure 9: Inflation



Domestic inflation rose to 8.5% over the year to February 2019 and contributed 3.8 percentage points to the headline inflation. Local food prices had the highest contribution of 2.9% followed by a 1.5% rise in the price of tobacco.

Figure 10: Domestic Inflation

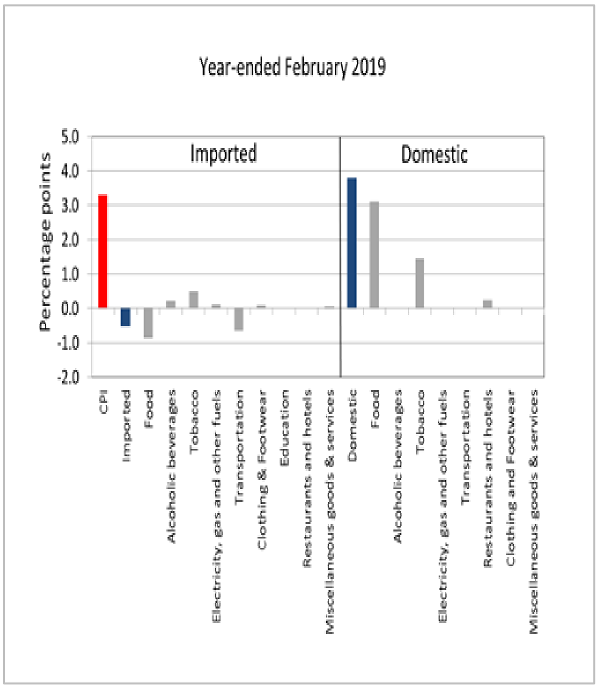


Local food prices rose over the year by 21.2%, which includes the prices of root crops and vegetables. This increase in prices of root crops and vegetables is attributed to the impact of TC Gita on the supply of root crops such as manioke (cassava) and the seasonal availability of vegetables. In addition, the price of tobacco also increased by 35.5%. School fees for secondary and tertiary institutes increased by 4.2%. Prices for catering services rose by 8.2%, whilst prices of other local goods also increased for goods and services for routine household maintenance and home repair. These price rises outweighed the annual decline in the cost of communication services such as telephone and telefax services.

Table 3: Food items contributing to domestic inflation

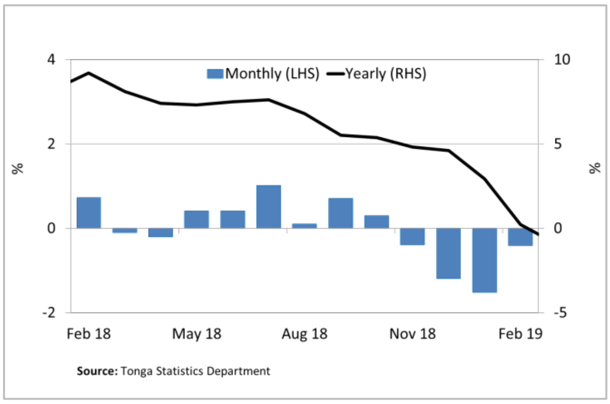
	($ per kg)		YOY	
	Feb 19	Feb 18	Annual changes $	% growth
Domestic				
H/Cabbage	5.34	1.62	3.72	229.63
Manioke	1.61	0.60	1.01	168.33
Capsicum	11.27	6.55	4.72	72.06
Talo - Tonga	2.23	1.50	0.73	48.67
Kumala	2.23	1.60	0.63	39.38
Cockles (to'o)	5.14	3.70	1.44	38.92
Talo - Futuna	1.91	1.42	0.49	34.51
Carrots	4.72	3.91	0.81	20.72
Yams - early	5.13	4.48	0.65	14.51
Octopus	22.10	19.39	2.71	13.98
Lu	4.90	4.43	0.47	10.61
Tomatoes	14.19	13.02	1.17	8.99
Tuna	16.00	15.00	1.00	6.67
Yams - late	3.17	2.99	0.18	6.02
Stringed fish (mixed)	8.00	8.00	0.00	0.00

Figure 11: Contributions to Inflation



Imported prices recorded an annual deflation in February 2019 of 0.9% which partially outweighed the rise in domestic prices by 0.5%. This was mainly due to the annual decrease in prices of imported food by 3.7% and oil prices by 6.6%. Imported food prices declined for meat items, fruits, and other goods such as sugar. World oil prices declined over the year to January 2019 by 10.2% which has a flow-through effect on the domestic fuel price with a lag of 1–2 months. The Brent crude oil was US$61.81 per barrel in January 2019 compared to US$68.83 per barrel in January 2018. This outweighed the rise in prices of tobacco, alcoholic beverages, and liquid petroleum gas.

Figure 12: Imported Inflation

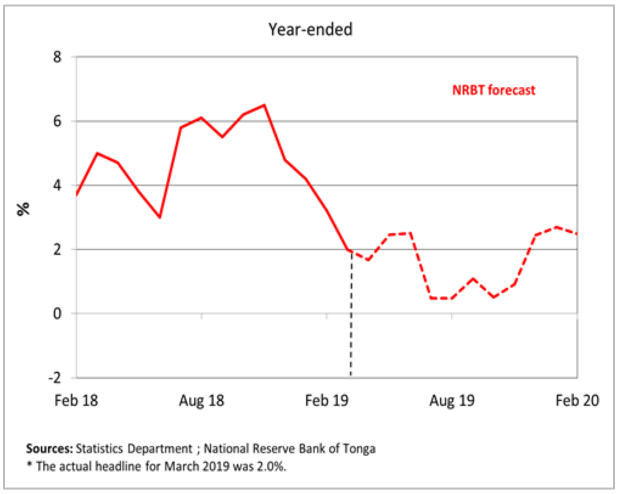


The price of imported tobacco, such as Pall Mall cigarettes rose by 29.2% to $19.29 per packet over the year. Further upward revisions to the excise tax of tobacco and alcoholic beverages that was effective in July 2018 contributed to the higher prices. Higher prices for imported goods over the year also applied for clothing and footwear supplies, liquid petroleum gas, paint, roofing iron and household appliances such as dishwashing liquid and washing machine. The strengthening of the USD currency against the TOP also contributed to the higher imported prices.

Outlook

The Reserve Bank envisions the yearly headline inflation to stay below its reference rate of 5% per annum in the medium term, although developments in worldwide food and oil prices may represent a risk to this expectation. Moreover, the vulnerability of Tonga to natural disasters also poses a risk to the prices of local food and the inflation outlook. The Reserve Bank will continuously monitor the sources of higher inflation, which includes the impacts of exchange rates and new taxes presented.

Figure 13: Headline Inflation Forecast

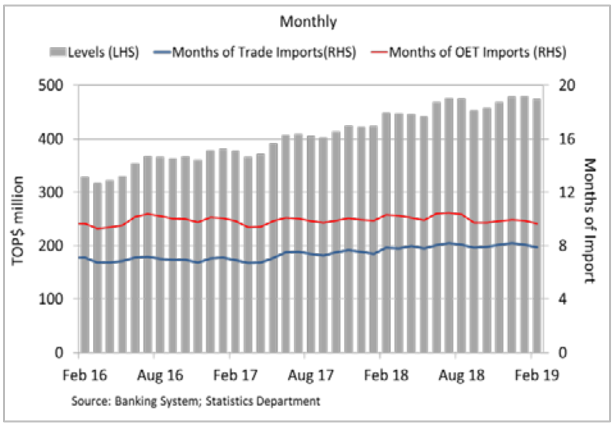


4. Maintaining Adequate Level of Foreign Reserves

The Reserve Bank continued to carefully monitor the country's external monetary position and to ensure that it maintains an adequate level of foreign reserves above 3 months of import cover. To monitor the external monetary position, estimates of the balance of payments position are derived from Overseas Exchange Transactions (OET) data collected from banks and authorised foreign exchange dealers (FEDs).

Official Foreign Reserves

Figure 14: Gross Official Foreign Reserves



Official foreign reserves continued to rise throughout 2018 and early 2019 corresponding to higher receipts of official and private grants and remittance related receipts. However, over the six months to February 2019 the foreign reserves declined by $1.5 million to $473.5 million, sufficient to cover 8.0 months of import of merchandise goods and services.

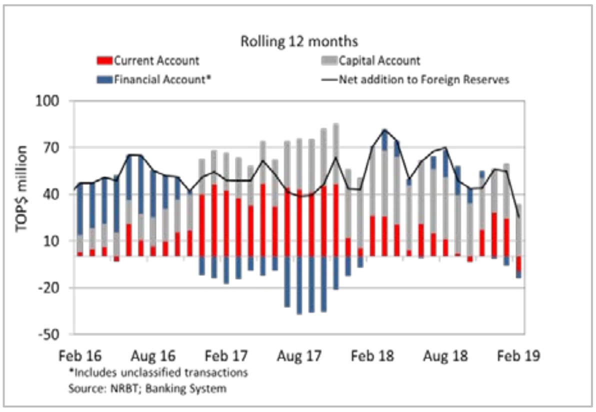
In year ended terms, gross official foreign reserves rose by $25.5 million due mainly to higher remittance receipts and higher receipt of foreign aid from donor partners, and budgetary support for the Government.

To maintain external stability and recognizing Tonga's vulnerability to natural disasters, the new Foreign Exchange Act 2018 came into force in July 2018, which consolidates the previous Foreign Exchange Act and Regulations. The new Act enhances the Reserve Bank's ability to better manage, and to maintain an adequate level of foreign reserves. The Reserve Bank implemented the requirements of the Act through the issue of its Exchange Control Directive which was effective on November 2018.

Balance of Overseas Exchange Transactions

Over the past six months to February 2019, the overall OET balance recorded a deficit of $1.5 million compared to a surplus of $27.0 million in the previous six months to August 2018. The overall deficit corresponds to a decline in the foreign reserves from $475.0 million in August 2018 to $473.5 million in February 2019. This decline was due to the widening of the current account deficit, and a lower financial account surplus, which outweighed the improvement in the capital account.

Figure 15: Balance of Overseas Exchange Transactions



Over the year to February 2019, the overall OET balance recorded a surplus of $25.5 million, which is lower than a $70.3 million surplus recorded in the year ended February 2018. This was mainly attributed to the widening of the merchandise trade deficit.

Current Account

The balance of the current account over the six months to February 2019 recorded a $10.7 million deficit, compared to a surplus of $1.1 million in the six months to August 2018. This was due to increased import payments followed by a decline in official, private and non-profit transfer receipts.

Annually, the current account balance recorded a deficit of $9.6 million compared to a surplus of $26.3 million in the year ended February 2018. The widening trade deficit continued to play a major role in the overall current account deficit, coupled with lower receipts of transport services over the year.

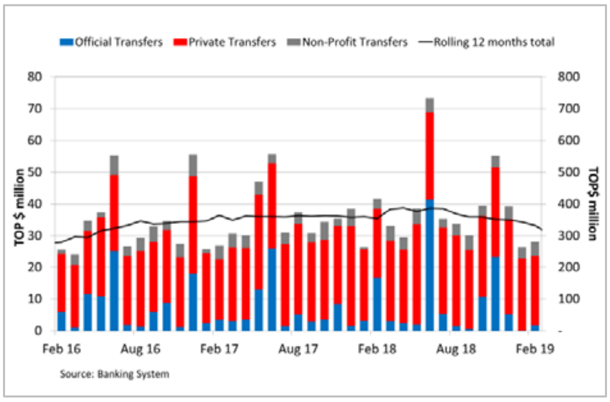
Current Account Receipts

➢ Transfer

Transfer receipts continued to account for the largest share in the current account receipts, at 64.5%. In the past six months to February 2019, the transfer receipts fell by $25.2 million due to decreases in all categories.

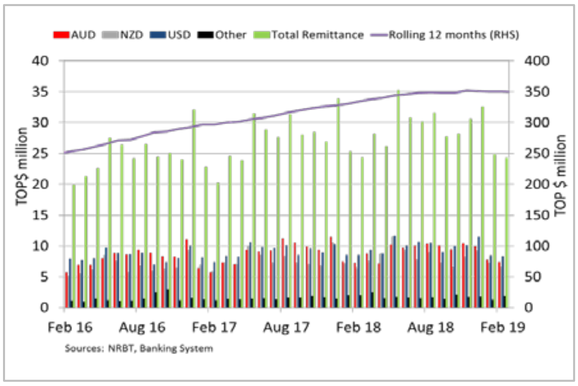
Contrastingly, total transfer receipts rose by 5.3% over the year to February 2019 to $461.4 million, as all categories increased led by private transfers, and followed by receipts of official grants and funds to non-profit organizations.

Figure 16: Transfer Receipts



Over the six months to February 2019, total remittance receipts declined by $13.9 million (7.6%) to $168.2 million. Approximately 91.1% of the total receipts were private transfer receipts with a total of $153.2 million, mostly gifts and family support funds from families and relatives abroad. The receipts for the compensation of employees (seasonal employees and other wages and salaries) followed with a total of $10.1 million (6.0%). Private transfers by individuals for capital investments totaled to $4.1 million (2.4%), and social benefits were $0.9 million (0.5%). Majority (86%) of remittances continued to be channeled via FEDs.

Figure 17: Remittances by Currency



Over the year to February 2019, total remittances however, rose by $16.0 million to $350.3 million, and accounted for 41.2% of the total OET receipts. It is estimated that remittances as a share of GDP is around 40%. Higher remittances were mainly due to receipts of family support from family and relatives overseas. This includes support for families who were affected by TC Gita, and to also cater for major celebrations throughout the year such as family reunions, churches' annual conferences, and individual construction and repair works. Most of the remittances are denominated in US dollars.

➢ Export

Over the six months to February 2019, the total export proceeds rose by $2.7 million (30.8%) to $11.6 million. The proceeds from exported agricultural produce and fisheries products both increased by $2.0 million and $1.2 million respectively. The higher proceeds from agricultural exports reflected the squash harvest season, while favorable weather conditions resulted in the increase of exported volume of fish and aquamarine products.

In the year ended February 2019, the total export proceeds remained relatively stable at $20.4 million, despite TC Gita and similar to that recorded in the year ended February 2018. Agricultural export proceeds rose by $2.4 million and outweighed the decline in proceeds from marine and other exports.

➢ Services

Service receipts for the six months to February 2019 rose by $1.0 million. This was attributed to higher tourism-related earnings which rose by $7.0 million coinciding with the increase in international arrivals. Receipts from construction and installation related services also rose by $2.7 million. These were partially outweighed by a decline in various services receipts such as transport-related, telecommunication and government services. Insurance claim receipts also declined following the large amounts received in the previous 6 months for insurance payouts on claims after TC Gita.

However, the total service receipts declined over the year to February 2019 by $1.3 million (0.6%) to $194.0 million which stemmed from lower receipts of telecommunication services, air transport-related services, and postal & courier services receipts.

These declines outweighed the increase in receipts from travel, professional services, construction & installation, and government services.

Current Account Payments

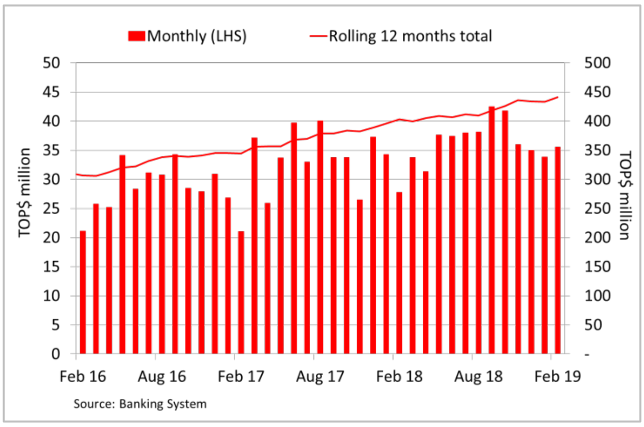
Total current account payments declined over the six months to February 2019 by $12.6 million to a total of $349.0 million due to lower payments for services, income, and transfer payments which outweighed the rise in import payments.

In contrast, over the year, the total current account payments rose by $64.1 million (9.9%) to a total of $710.7 million driven by rises in all categories of current account payment except for primary income payments.

- Imports

Merchandise import payments remain as the largest outflow from the current accounts, rising by $8.4 million in the past six months to February 2019. All categories of import payments increased (except for construction material imports) led by a $5.1 million rise in wholesale & retail, followed by a $4.7 million increase in oil imports payments. Other imported goods which are mostly the Government's imports (public enterprises) also increased by $2.5 million, which included materials for projects funded by donor partners.

Figure 18: Import payments



Similarly, import payments continued to rise over the year by $38.0 million (9.4%) to $440.8 million driven by rises in all import payment types. Wholesale and retail import payments rose the most by $17.4 million followed by a $9.5 million increase in Government's imports. Payments for motor vehicle and oil imports also rose by $5.4 million and $2.0 million respectively. Continued growth in the distribution sector contributed to the increase in wholesale and retail trade import payments, which coincided with the 16.4% increase in container registrations over the year.

- Services & Transfer payments

Payments from both the service and transfer accounts slowed over the six months to February 2019 compared to the six months to August 2018. Service payments fell by $12.1 million due to lower shipping and travel-related services, professional & consulting business services and payments for government services. Transfer payments declined over the six months to February 2019 by $1.0 million as official contributions and subscription payments to international organizations fell by $2.5 million, which was partially outweighed by the rise in private transfers, particularly remittances sent abroad.

However, over the year to February 2019, both service and transfer payments rose by $38.1 million and $6.3 million respectively. Higher service payments were attributed to higher payments for sea and air transport payments coupled with higher personal travel payments and payments for other private services. The increase in transfers from individuals abroad for family support and transfers to their own accounts overseas, led to the rise in the overall transfer payments.

- Primary Income payments

In the six months to February 2019, primary income payments fell by $7.9 million and further declined over the year by $18.3 million. This was a result of a decline in dividends being paid out to non-resident shareholders, and wages and salaries to expatriates overseas.

Capital Account

A net inflow of $17.2 million was recorded in the capital account for the six months to February 2019 and was driven by increases in both private and official capital transfers by $12.0 million and $5.2 million respectively. The private and official capital payments increased but were outweighed by higher private capital transfer receipts for investment projects or capital expenditures for construction purposes.

In year ended terms, the capital account continued to record a surplus of $33.4 million, lower than the $43.9 million surplus recorded in the year ended February 2018. This was driven by lower surpluses in both the official and private capital accounts. Higher receipts in the private transfer accounts outweighed the higher payments on both accounts. Higher receipts by private companies and individuals for investment projects and capital expenditures drove the higher private capital receipts. This was also supported by Government receipts from foreign aid funds for capital expenditures and investment projects such as the Nuku'alofa Network Upgrade and Fua'amotu International Airport Construction Works.

Financial Account

In the past six months to February 2019, the balance in the financial account recorded a surplus of $14.7 million, lower than a surplus of $51.8 in the previous six months to August 2018. This surplus was underpinned by higher receipts from other investments outweighing the payments for direct and portfolio investments such as repayments of intercompany lending funds and investments in real estate.

Over the year to February 2019, the financial account recorded a surplus of $66.5 million, almost double the surplus of $35.0 million recorded in the year ended February 2018. This reflects an increase in inter-bank transfers and the repatriation of deposits by Tongan residents.

The balance of unclassified transactions recorded an average outflow of $5.4 million per month over the year to February, compared to $2.9 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.

Exchange Rates

The Nominal Effective Exchange Rate (NEER) index remained stable at 91.5 over the six months to February 2019, which indicates that the TOP also remained relatively stable against its major trading currencies. Imports may have also been less expensive relative to the last six months due to the depreciation of USD, AUD, EUR, and FJD against the TOP.

The Real Effective Exchange Rate (REER) index also declined by 1.5%, reflecting the impact of Tonga's moderating inflation rate relative to its major trading partners, thus improving Tonga's international competitiveness. In year ended terms, both the NEER index and the REER index rose by 1.3% and 2.2% respectively 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 months of import up to June 2020 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 2019 such as the family month of May followed by annual church conferences and school anniversaries. The rising number of people joining the RSE & SWP schemes also contributes to the expectation of higher remittance receipts.
- Banks and foreign exchange dealers are expanding their range of products and services offered to customers such as the TDB Ave Pa'anga Pau product. It also includes the expansion of the payment infrastructure as banks open new agents in the outer islands, as well as extending services in their overseas agents, would further support remittances and other financial receipts.
- Expected growth in the agricultural and fisheries activities is expected to boost export proceeds, yet the anticipated rise in import payments will likely offset this.
- Tourism activities such as whale watching, proceeds from artisanal handicrafts, sea cruises and more airline routes are expected to support travel receipts.
- Expected receipt of budgetary support for the current financial year.
- Government receipt of project funds and other assistance from donor partners for on-going construction projects and recovery from damages caused by TC Gita.

- The implementation of the Foreign Exchange Control Act 2018 provides measures to monitor and better manage the foreign reserves as well as an essential tool in the contingency plan should the foreign reserves fall to critical levels.

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

- Delays to the inflow of aid and budget support from development partners combined with the pace of development in domestic economic activities pose a risk to the foreign reserves outlook.
- The significant rise in external debt service to Export-Import (EXIM) Bank of China as the principal repayment of the Tonga National Road Improvement Project loan commences in the financial year 2019/20.
- Placement of large investments offshore.
- Uncertainty in the commodity prices may have negative implications on Tonga's external position as a net importer and price taker.
- De-risking by banks resulting in the closure of Money transfer operators accounts. This would have a negative impact on remittances and increase the cost of money transfer.
- Vulnerability to natural disasters also remains a risk.

5. Promoting a Stable Financial System

The banking system continued to remain sound over the 6 months to February 2019. Banks maintained a strong capital position accompanied by their comfortable profitability, high liquidity, and low level of non-performing loans. The strong credit growth was consistently maintained as the total banks' lending reached a new high record in February 2019. The total bank deposits were also maintained at a high level despite the slight decline, reflecting the increase in the foreign reserves. The weighted average interest rate spread widened over the 6 months to February 2019.

Money Supply

After reaching the second-highest point of $606.0 million in the last six months to August 2018, broad money slowly fell by $17.0 million (2.8%) to $589.0 million in the six months to February 2019. The decline was a combination of a $15.5 million decrease in net domestic assets and a $1.5 million decline in net foreign assets. The lower net domestic assets were primarily driven by the decline in net credit to government mainly on increased government deposits due to the receipts of budget support and grant funds from development partners. Consequently, the lower foreign reserves was the main driver of the decline net foreign assets.

In year ended terms, the higher net foreign assets and the slight rise in net domestic assets resulted in a $30.8 million (5.5%) increase in broad money. The higher foreign reserves from receipt of government budgetary supports and project funds continued to push foreign assets up over the year, while increased credit to the private sector contributed to the rise in net domestic assets.

The Reserve Bank continued its efforts to improve the quality of banknotes and coins in circulation, and at the same time meet public demand and the commercial banks' demand for certain denomination of banknotes and coins. The increase in the number of access points for both banks and non-bank financial institutions, mainly for EFTPOS and agents/in-store banking, contributed to the rise in currency in circulation. The Reserve Bank's Currency Department continued to undertake direct deposits of mint quality notes to the Reserve Bank's note trust depots in the outer islands for the interchanging and replacing of mutilated notes with good quality currency notes on a timely manner.

Liquidity in the banking system (reserve money) decreased to $320.6 million in the six months to February 2019, after recording a new high record of $334.2 million in the last six months to August 2018. Both the commercial banks' deposits to the Reserve Bank's vault and the currency in circulation

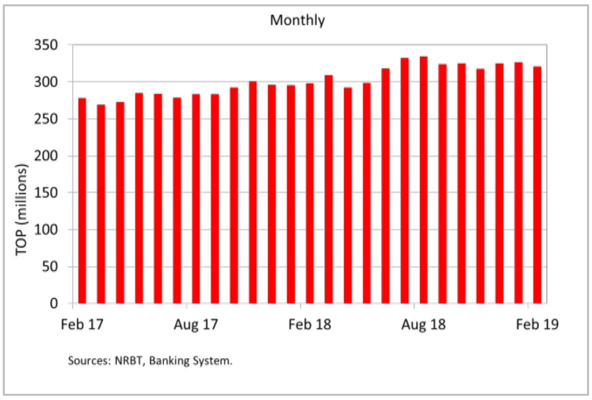
Table 4: Consolidated Balance Sheet of Depository Corporations

	Level			YoY Change	
	Feb 18	Aug 18	Feb 19	Feb 18	
	$TOPm	$TOPm	$TOPm	$TOPm	%
Broad money liabilities	558.2	606.0	589.0	30.8	5.5
Currency in circulation	65.8	69.0	60.5	-5.3	-8.1
Demand deposits	181.8	212.2	217.4	35.6	19.6
Savings and term deposits*	310.5	324.8	311.1	0.6	0.2
equals					
Net foreign assets	468.1	494.1	492.6	24.5	5.2
plus					
Net domestic assets	90.3	112.2	96.7	6.4	7.1
Gross bank lending**	442.9	461.3	490.0	47.2	10.6
Public enterprises	52.9	56.2	58.3	5.4	10.3
Private Sector	387.9	402.5	429.3	41.4	10.7
Other financial corporations	2.0	2.6	2.3	0.3	14.9
Other***	-352.5	-349.1	-393.3	-40.7	11.6

* 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.
Sources: Banking system; NRBT

decreased, which is in line with the lower deposits recorded over these six months. Statutory required deposits, however, slightly rose over the same period.

Figure 19: Banking system liquidity



Over the year to February 2019, liquidity in the banking system continued to rise by $23.0 million (7.7%), due to higher deposits by the commercial banks to the Reserve Bank's vault coupled with the increased statutory required deposits.

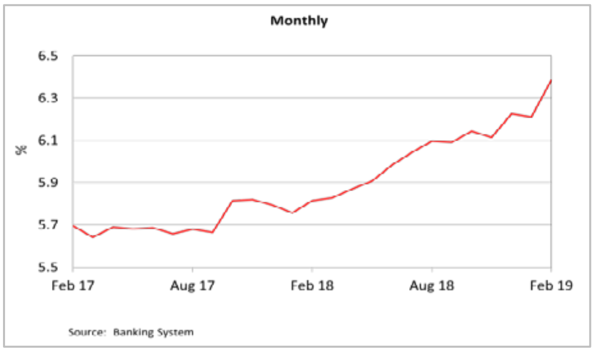
The banks' total loans to deposit ratio rose from 71.5% in August 2018 and 74.3% in February 2018 to 76.0% in February 2019. The six months rise was due mainly to the growth in lending and the decline in deposits, while the annual increase was attributed to loans rising at a faster pace than the growth in deposits. However, despite the increase in lending, the ratio remained below the 80% minimum loan to deposit ratio, indicating that there is still excess liquidity in the banking system for further lending. The Reserve Bank will continue to monitor the growth in loans to avoid any overheating in the economy and any potential threat to financial stability.

Interest Rates

The banks' weighted average interest rate spread widened over the six months to February 2019 by 28.9 basis points to 6.39%. This resulted from an increase in the weighted average lending rate by 21.1 basis points (from 8.08% to 8.29%), and a decline in the weighted average deposit rate by 7.8 basis points (from 1.98% to 1.90%). The higher weighted average lending rate was largely driven by the increase in the average interest rates on loans to the public enterprises, individual's vehicle loans and private businesses mainly in the fisheries, manufacturing and distribution sectors. The lower weighted average deposit rates were due mainly to lower time deposit interest rates for all terms except for the over five year's term.

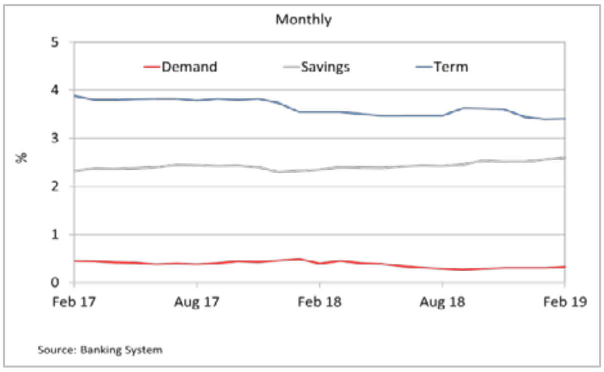
Similar trends were also observed over the year, the weighted average interest rates spread widened by 57.0 basis points due to higher weighted average lending rates (36.5 basis points) and lower weighted average deposit rates (20.43 basis points). Again, interest rates on loans to the public sector increased as well as the individual's housing and other personal loans, and also private businesses such as manufacturing, fisheries, and distribution businesses.

Figure 20: Weighted Average Interest Rates Spread



The declining weighted average deposit rates stemmed from lower demand and time deposit interest rates for all terms except for the over five years term. The decrease in total deposits over the year also supported the annual trend.

Figure 21: Deposit Rates



Lending

The total banks' lending (including GDL) climbed to a new high record of $483.7 million over the six months to February 2019. This was a $26.2 million (5.7%) increase from $457.5 million recorded in August 2018. This stemmed from a 7.6% rise in business loans coupled with a 3.9% in household

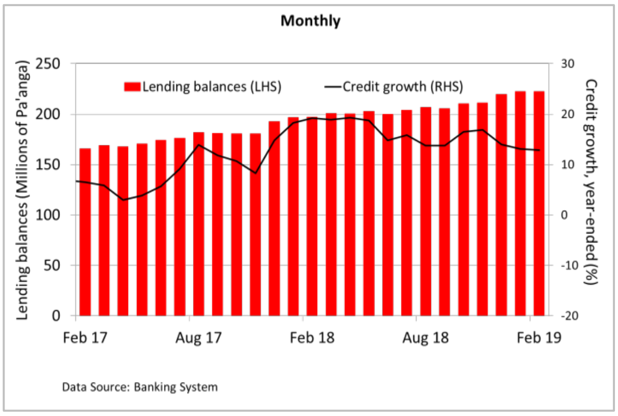
Table 5: Lending Rates
Weighted average of all banks

	Month ended			Change over 5 months to		Loan Share	
	Feb 19	Aug 18	Feb 18	Feb 19	Aug 18	Feb 19	Aug 18
	%p.a.	%p.a.	%p.a.	Bps	Bps	%	%
Loans all	8.29	8.08	7.92	21.13	15.40	100	100
Housing	8.24	8.19	8.10	5.40	8.78	42	43
Other personal	11.45	11.39	11.34	6.02	4.52	12	13
Business*	7.83	7.74	7.43	8.42	31.43	29	28
Other	6.25	6.25	6.25	0.00	0.00	17	17

*Included Statutory Non-financial Corporation and Other Financial Corporations

loans. GDL accounted for 1.5% of the total loans, compared to a 1.9% share in August 2018.

Figure 22: Business Lending

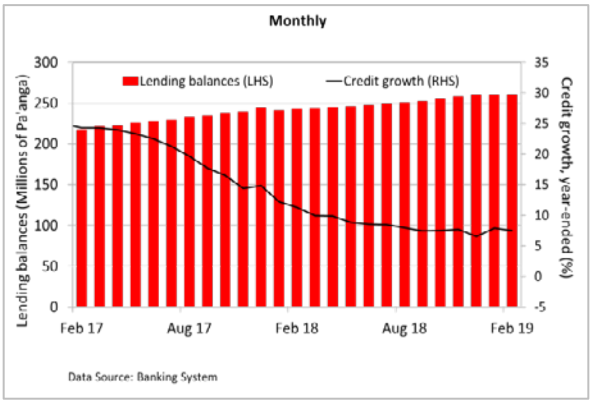


The expansion in lending to businesses was mainly for the transport, wholesale & retail, manufacturing, and construction sectors. This reflected growth in the private sector, business confidence and further indicates businesses stocking up in preparation for the festive season, church conferences, family reunions, and other on-going infrastructural projects over the six months to February 2019. Other business developments are yet to be completed, such as the Kongakava Boutique Hotel in the tourism sector.

Households' loans reached a new high record of $260.8 million in February 2019, driven mainly by an increase in both housing and other personal loans. This continues to indicate the consistent demand for housing loans by individuals and the post-TC Gita cyclone reconstruction.

The rising new loan commitments will also contribute to the credit growth once drawn down, as it rose by 13.9% ($1.7 million) over the six months to February 2019. Most of these new loan commitments were for the public sector, individuals, and tourism and transport sectors.

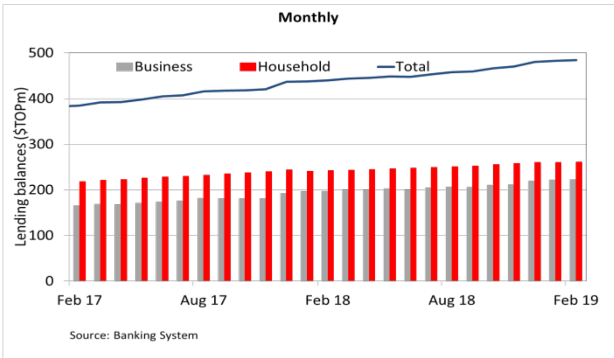
Figure 23: Household Lending



Total banks' lending, continued its upward trend over the year to reach a new record high in February 2019, increased by 10.1% ($44.2 million) from the $439.5 million recorded in February last year. Again, lending to both businesses and individuals rose over the year by $25.3 million (12.8%) and $18.2 million (7.5%), respectively.

Higher loans offered to the public sector, transport, wholesale & retail, tourism, and construction sectors contributed to the growth in lending to businesses, and further indicates the increased investments made by these sectors. The higher wholesale & retail loans coincided with the 16.4% rise in container registrations and the 7.3% rise in wholesale & retail imports. Similarly, the increase in construction loans was in line with the 4.9% rise in the import of construction materials. The lower interest rates from the GDL scheme also supported these sectors' developments.

Figure 24: Bank's lending



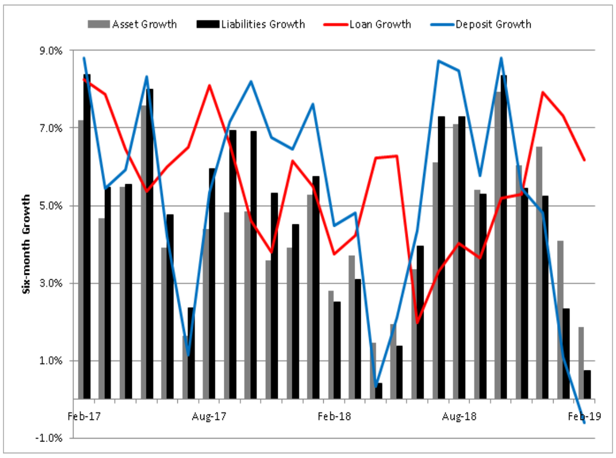
Housing loans continued to be the primary driver of the increased household loans, rising by $15.9 million (8.6%) over the year to February 2019. Other personal loans supported the trend with an increase of $3.6 million (6.4%), over the same period.

Lending activities by the non-bank financial institutions[3] also increased over the year by $18.5 million (12.2%). Lending to households increased by $20.4 million (20.2%) offsetting the fall in Government Development Loans.

Banking System Performance

The banking system remains sound during the six months to February 2019. Total assets increased by $16.2 million (1.9%) to $882.8 million. This was due mainly to 6.2% ($27.8 million) growth in loans and advances, followed by an increase in non-financial assets by 8.4% ($3.9 million). This was offset by a decline in balances with depository institutions since August 2018 of $16.3 million (5.4%), mainly due to the decline in the banks Exchange Settlement account by $8.7 million to fund the drawdown in customer's deposits. Similarly, total liabilities also increased by $5.1 million (0.7%) to $708.9 million which was attributed mainly to a 27.3% ($2.4 million) and 14.3% ($2.0) increase in total borrowings from head offices to fund foreign currency loans, and the implementation of the new IFRS 9 provisioning requirements which led to an increase in provisions for losses over the past six months from August 2018. This was offset by the decline in total deposits by 0.6% ($3.7 million) mainly term deposits which fell by 5.4% ($13.8 million) due to the implementation of the Exchange Control Directive and the requirements on foreign currency accounts. As a result, these foreign currency term deposit accounts were then converted to demand deposits which drove the 2.7% ($7.4 million) increase in demand deposit.

Figure 25: Total Banking System Balance Sheet Development



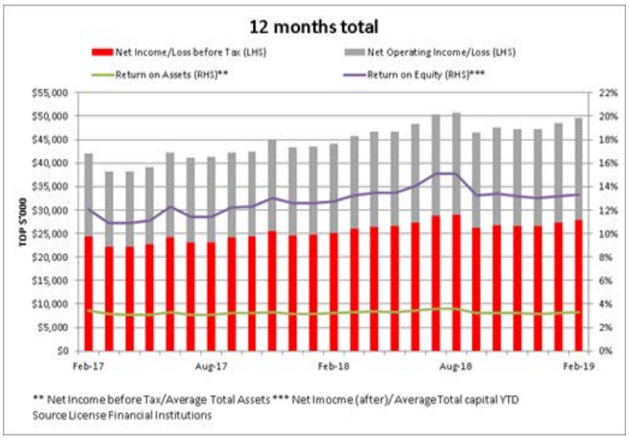
The total banking system remained profitable over the year to February 2019. The Net Profit after Tax was $21.6 million, decreasing from $22.9 million in August 2018 but higher compared to the same period last year, which was at $19.1 million. The ongoing improvement in profitability was driven by the increase in interest income from the continuous growth in banks' loan portfolio and the lower non-interest expenses. The lower profit over the 6 months was due mainly to the increase in provisions for loan losses on the implementation of the IFRS 9 provisioning requirements.

Return on Assets (ROA) and Return on Equity (ROE) decreased over the past six months. Although the ROA slightly eased to 3.3% from 3.6% in August 2018, banks profitability continued to improve compared to last year. Similarly, the ROE decreased to 13.4% from 15.1% in August 2018 driven by an injection of capital investment into one of the banks during August of $7.5 million, which offset the improved profitability of the banks over the 6 months to February 2019. The banking system's capital position remained strong as the risk-weighted capital ratio was at 30.9% in February 2019 increasing from 28.8% in August 2018 and continued to stay well above the Reserve Bank's minimum requirement of 15%. The higher risk-weighted capital ratio reflected the increase in capital outweighing the increase in risk-weighted assets over the 6 months to February 2019. The banks' net interest margin increased to 3.8% in

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

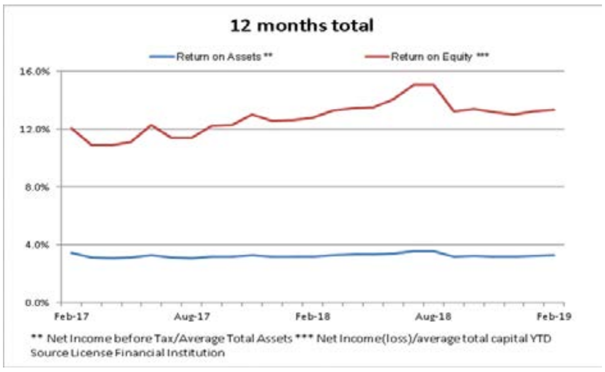
February 2019 from 3.5% in August 2018. This continued to reflect an increase in interest income as weighted average interest spread widened due to higher lending rates and lower deposit rates over the six months.

Figure 26: Total Banking System's Profitability



The overall quality of the banks' assets weakened over the past six months to February 2019. Total non-performing loans slightly increased to $17.2 million from $16.9 million, which represents only 3.6% of total loans compared to 3.8% in August 2018.

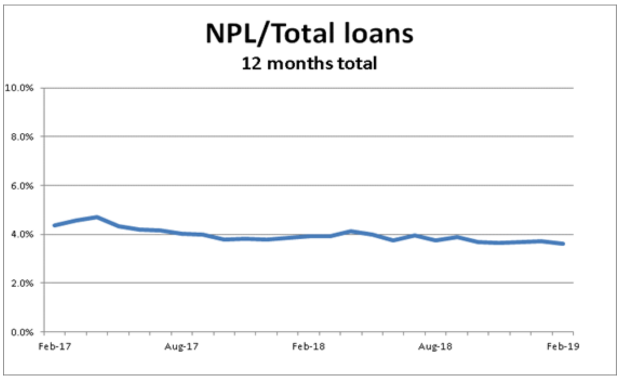
Figure 27: Total Banking System's ROE & ROA



The non-performing private individual loans rose to 61% of total non-performing loans, from 60.2% six months ago, and 51.2% around the same time last year. Non-performing private individual loans comprised mainly of housing loans representing 44.6% of total non-performing loans decreasing from 45.8% in August 2018, but increasing from 36.1% in February 2018. The decline in non-performing housing loans reflected loan upgrades during that period.

Provisions against loan losses rose over the last six months from $13.9 million to $16 million in February 2019 due to the increase in non-performing loans. The banks' compliance with IFRS 9 on provisioning requirements also increased the provisions.

Figure 28: Total Banking System Asset Quality Indicators



The Reserve Bank continued to monitor and manage the payment and settlement system to ensure it is functioning in an efficient, sound, and safe manner. Work is currently in progress on automating the current national payment system to improve the efficiency of the settlement of banks' transactions at a reasonable cost.

Supervision of Non-Bank Financial Institutions (NBFIs)

The Reserve Bank continues to advocate the regulation of non-bank financial institutions mainly to promote access to finance at the same time protect the interest of customers. In addition, it is to mitigate potential systemic risks posed by large NBFIs such as retirement funds and insurance companies, on the total financial system. In this regard, the supervision and oversight of non-bank financial institutions remain work in progress. The supervision and regulation of Foreign Exchange Dealers were enhanced under the Foreign Exchange Control Act 2018 which came into effect on the 21st June 2018 and the Exchange Control Directives which was effective on the 1st November 2018. The Reserve Bank has licensed 12 foreign exchange dealers under the Foreign Exchange Control Act 2018 and is currently working on licensing one microfinance institution under the Microfinance Institutions Act 2018. Close collaboration continues with stakeholders to ensure compliance with the Microfinance Act before it is proclaimed to come into effect by the end of May 2019 and to implement the Money Lenders Act in the next financial year. The legislation for the supervision of insurance companies and retirement funds are also being drafted.

Although the legislation is not in place, the Reserve Bank has obtained monthly reports from the 2 retirement funds, 1 microfinance, and quarterly monthly reports from 4 insurance companies. The purpose of these reporting templates is to understand the type of business that these NBFIs are conducting and also to monitor their financial positions and performance to ensure they are solvent.

Outlook

The stability of the financial system will be maintained going forward on the close monitoring and supervision of banks and non-bank financial institutions through various policy measures outlined below:

- The Reserve Bank maintains its forecast for credit growth to rise by 13% in 2018/19. Furthermore, although non-performing loans remain at low levels, the household sector non-performing loans are slowly rising, but still low. Close monitoring of these developments in the financial system for any sign of overheating in the economy is part of Bank Supervision team's on-site and off-site monitoring.
- Broad money is also projected to increase in June 2019 by 10%, supported by the anticipated rise in lending and the foreign reserves. This growth may wind down eventually in 2019/20.
- Formalizing the non-bank financial institutions and the informal financial sector by developing the legal framework to supervise insurance companies, retirement funds and microfinance institutions.
- The Reserve Bank's initiatives to develop an enabling financial infrastructure would further support credit growth. However, structural reforms to improve the credit environment, such as improvement to the land administration system and a bankruptcy law would further improve the confidence level of the banks to continue lending out prudently.
- Ensure compliance with the disclosure requirements under prudential and regulatory requirements for banks' and foreign exchange dealer's customers. The Reserve Bank also requires that the Annual Percentage Rates (APR) is stated in the loan agreement and this loan agreement is to be translated into Tongan. This will enhance transparency and the disclosure of fees and charges, Annual Percentage Rates (APR) on loan products, and foreign exchange rates.
- Continue to develop an enabling financial infrastructure to license and supervise the existing credit bureau (Data Bureau (Tonga) Limited) under the Reserve Bank's Credit Bureau Licensing Guideline that was issued on July 2017. The credit bureau will contribute to the mandate of maintaining financial stability. It would also assist with prudential supervision to monitor systemic risks and the quality of banks assets as well as enhance access to loans.
- Modernize the payments system by automating the daily bank's cheque settlement system to improve the efficiency of the financial system further.
- Continue to work together with Pacific Central banks and other stakeholders as well as the authorized restricted foreign exchange dealers to strengthen their Anti-Money Laundering / Counter Financing Terrorist (AML/CFT) compliance status for the banks to retain their accounts.
- Support new digital and innovative products in the financial system such as the TDB 'Ave Pa'anga Pau product and its expansion to Australia
- Encourage the development of technological solutions (FinTech) that would facilitate the low-cost remittance of funds and at the same time, still comply with the AML/CFT requirements.

Risks to this outlook and the stability of the financial system include:

- The rate of growth in credit and nonperforming loans as well as broad money
- The banks' de-risking decisions which have resulted in the closing of some of the foreign exchange dealers' accounts as well as the termination of correspondent banking relationships of some of the banks.

6. Fiscal Indicators

The fiscal position has improved over the six months to February 2019. Net credit to Government in the banking system fell by $24.8 million (16.0%), compared to an increase of $9.8 million (5.9%) over the previous 6 months to August 2018. This was due to a 14.3% ($23.9 million) rise in Government deposits reflecting higher government revenue collection during the past six months. This increase in revenue collection includes the dividends received from Public Enterprises, the implementation of higher excise taxes, and the high customs and duty collected during the festive season. These were also supported by the receipts of budgetary supports, project grants and cyclone relief funds from development partners.

Similarly, net credit to Government also decreased over the year by $15.0 million (9.1 %), due to a $15.4 million (8.8%) rise in Government deposits. The receipt of some of the budgetary support, grants and cyclone relief funds from development partners, higher remittances, and better revenue collection during the financial year largely contributed to this increase in Government deposits.

The 2018/19 Government revised budget estimated the receipt of $43.5 million in budget support from development partners, in which only $14.2 million has been received to date, and the remaining budget support is expected to be received by the end of the financial year. However, the delayed budgetary support of $21.9 million from the World Bank that was budgeted for 2017/18, was received on November 2018. This contributed to the increase in foreign reserves during the past 6 months to February 2019.

The total public debt position for June 2019 is estimated to represent 55% of GDP, of which 49% is external debt and 7% is domestic debt. This is in line with one of the three fiscal targets in the Government of Tonga Fiscal Strategy for 2018/19, which is to maintain the external debt below 50% of GDP. The other two targets are to raise domestic revenue collections to at least 22% of GDP and to maintain the compensation of employees at no more than 53% of domestic revenues and to gradually decline to 50% over time.

The estimated total debt service for 2018/19 is to remain at over $10 million, where the majority of this debt service is to finance the external loan repayments. The projected external debt service for 2019/20 remains at more than $20 million due to the commencement of the first principal repayment for the Tonga National Road Improvement Project loan due in March 2020 to EXIM Bank of China. The principal repayment of the Nuku'alofa Central Business District Reconstruction loan that was due on September 2018 has been deferred to September 2023. The main repayment months for the loans to the EXIM Bank of China are September and March of every year. The EXIM Bank of China remains the main external debt creditor, hence the Chinese Renminbi has the highest share of the total external debt portfolio.

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

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

7. Monetary Policy Stance

The Reserve Bank's monetary policy stance remained accommodative during the past six months to February 2019. Inflation has returned below the 5% reference rate in December 2018, while foreign reserves continue to be at a comfortable level above the minimum of 3 months of import cover. Exchange rates were competitive, and the financial system remained sound supported by strong capital and liquidity position. The domestic economic indicators are also suggesting positive growth during this period. No sign of overheating was observed in the financial system, despite the strong credit growth. However, the banks' loans/deposit ratio remained below the 80% loan to deposit target, which indicates excess liquidity remains in the financial system.

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

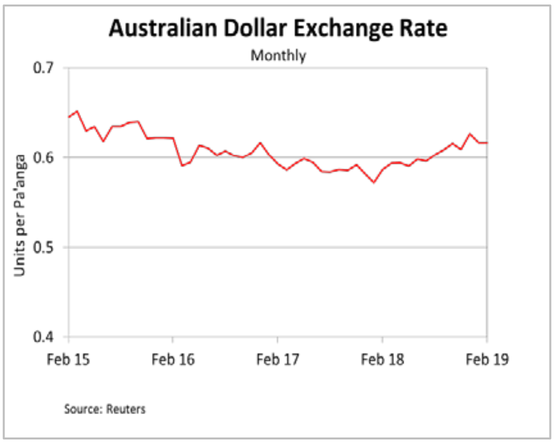
Inflation is expected to remain below the Reserve Bank's inflation reference rate of 5% per annum throughout 2019.

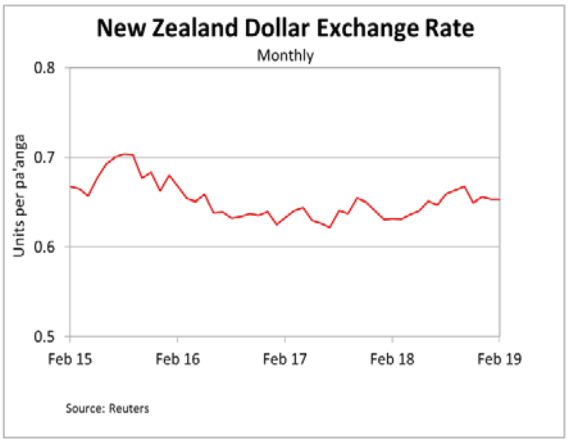
Given the recent developments and the outlook on the monetary policy targets, the current accommodative monetary policy stance is considered appropriate in the medium term. Therefore, these monetary policy measures will remain unchanged in the medium term to encourage the utilisation of the excess liquidity in the banking system to increase lending, particularly to developing sectors, to support domestic economic growth and strengthen the monetary policy transmission mechanism.

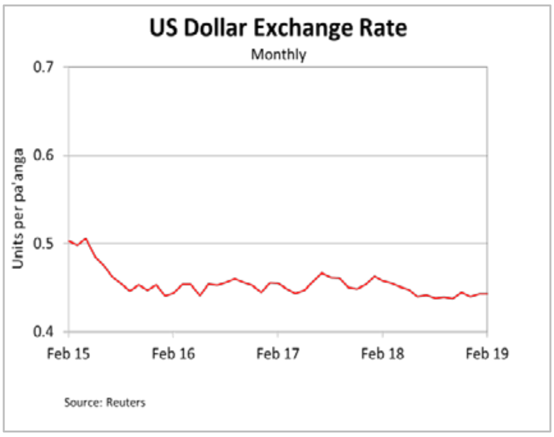
- ✓ Maintain the monetary policy rate (interest rate on banks' exchange settlement accounts or excess reserves) at 0% (zero interest rate policy);
- ✓ Maintain the minimum loans/deposit ratio at 80%;
- ✓ Maintain the Statutory Reserve Deposit ratio at 10%;
- ✓ Maintain the inflation reference rate at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

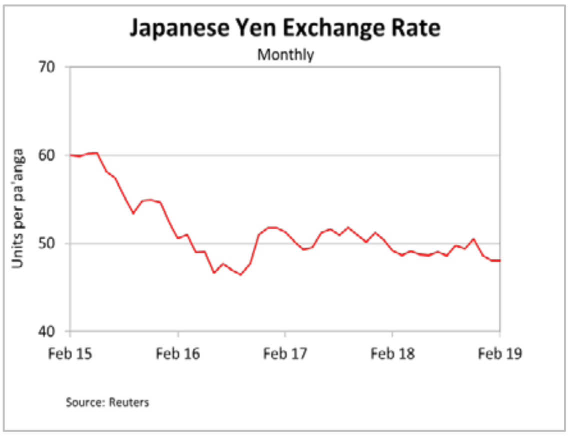
The Reserve Bank will remain vigilant and continue to closely monitor developments for early signs of vulnerabilities which may indicate overheating of the economy. Furthermore, the Reserve Bank will continue to closely monitor developments in the domestic and global economy, and update its monetary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

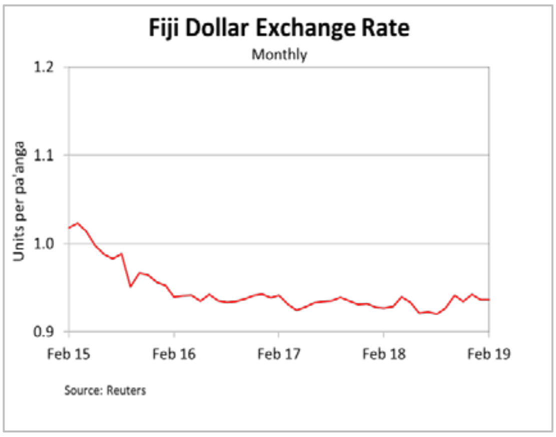
Appendix 1: Tongan Pa‘anga Exchange Rates

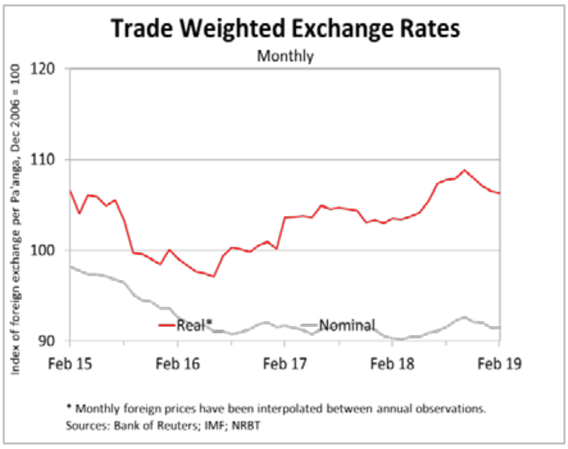












Appendix 2: Monetary Policy Objectives

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

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

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

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

Maintaining an adequate level of foreign reserves is vital for a small open economy such as Tonga. It is dependent on imports for the supply of most of its goods, which needs to be paid for in foreign currency. Given Tonga's vulnerability to external shocks and natural disasters, its small size, narrow export base, and dependence on imports, it is imperative that foreign reserves are maintained at an adequate level to meet individuals' needs for basic essentials and support economic growth. The Foreign Exchange Act 2018 enhances the Reserve Bank's ability to safeguard the country's foreign reserves.

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 55% 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, better economic performance, and sustainable economic development. 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 raised prosperity for Tonga.