



QUARTERLY

ECONOMIC

UPDATE (March 2015/16)

(May 2016)

**NATIONAL PLANNING & ECONOMIC DEVELOPMENT DIVISION
MINISTRY OF FINANCE & NATIONAL PLANNING
GOVERNMENT OF TONGA**

Notes

- a) The following definitions are used in the Quarterly Economic Update (QEU):
- 'Real' means adjusted for the effect of inflation
 - The fiscal year (FY) of the government ends on 30 June. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2016 ends on 30 June 2016
 - Forecast period refers to 2015/16 – 2018/19.
- b) Figures in the tables and text have been rounded. Discrepancies in tables between totals and sums of components are due to rounding.
- c) The following notations are used:
- nil
 - na not applicable (unless otherwise specified)
 - \$ refers to Tongan Pa'anga (TOP) (unless otherwise specified)
 - \$m millions of Pa'anga (TOP) (unless otherwise specified)
 - (e) estimates (unless otherwise specified)
 - (r) revised estimates (unless otherwise specified)
 - (p) projected (unless otherwise specified)
- d) The following acronyms referred to as:
- | | |
|------|---|
| NRBT | National Reserve Bank of Tonga |
| OET | Overseas Exchange Transactions |
| TSDF | Tonga Strategic Development Framework 2015-2025 |

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OVERVIEW

This Quarterly Economic Update presents an update on a number of key selected economic indicators that provide useful information on economic activity during March 2016 quarter.

During the review quarter, activities under the primary sector had slowed down supported by lower agricultural exports – reflecting the end of squash season. However, fisheries exports are anticipated to continue to increase over the quarter supported by the increase in exports of tuna and snapper during the month of February 2016.

Activities under the secondary sector remain strong and continued to be dominated by construction activities which also have a ripple effect on other industries of the sector. Strong growth in the construction activities is consistent with the increasing number of building permit issued supported by both the ongoing donor-funded projects and private constructions.

The activities in the service sector was mixed over the review quarter supported by the slowdown in wholesale and retail trade due to lower imports, decreasing travel receipts and arrivals. However, there was an observed increase in the public administration and services through the number of vacancies that were advertised during the quarter. There were also number of developments took place in the transport and communication industry such as the effective operation of the new direct flight between Fiji and Vava'u, more cruise arrivals, increase in the number of voyage of the inter-island ferry as students and employees return back to school and work after the Christmas and New Year holidays. The industry was also benefitted from the lower oil prices.

Positive outlook for Tonga over the forecast period supported from all positive developments anticipated from various sectors including events and construction projects as mentioned above, favorable inflation rate and reasonable oil prices. However, there are potential risks that might affected our expected positive growth over the forecast period included if weather conditions and El Nino continue it could limits production in the primary sector. If there will be delays in the implementations of major construction projects or scaled back it could lead to a weaker growth in the near term but somewhat stronger in the medium term. It is also a risk to Tonga if economic conditions of its main trading partners become weaker, it could decrease remittances and demands for exports. Last but not the least, if there will be a sharp increase in the global commodities prices it could increase cost of production, raise inflation and reduce house real incomes.

However, weaker economic growth combined with weaker inflation leads to lower nominal GDP and this could lead to lower revenue and somewhat led to high debt ratios.

Provisional figures indicated that both domestic revenue and cash grants decreased at the end of March Qtr 2016 compared to previous quarter while increased when compared to same period a year ago. The declined in the quarterly trend reflected the after festive season as tax collection have dropped from various tax items such as lowered collection from motor vehicle taxes, customs and other import duties, CT and excise taxes. The increased on annual

basis was supported from an increase in the collection mainly from the PAYE (both from employees and companies), customs and other import duties. Grants increased over the quarter compared to December quarter was supported by various projects funded by NZ, WB/IDA, SPREP, SPC and many other donors. For March quarter 2016 only, domestic revenue (tax and non-tax) collected was equivalent to 22% of the original budget for the current financial year, 2015/16.

Provisional figures for Public Expenditure at the end of the review period was higher than both the December quarter 2015 and same period a year ago. The increased in the quarterly trend was due to an increase in the social contribution, subsidies to non-financial private enterprises, interest payments to non-resident and to resident other than general government, social security benefits and other expenses. The increased on year-on-year basis was supported by the increase in payment of wages and salaries as results of the recent 5% COLA implemented in this financial year, increase in payments for use of goods and services including interest payment to non-resident and resident other than general government as well as other expenses. The overall public expenditure to March quarter 2016 was equivalent to 50% of the original estimates for 2015/16, of which 35% was for March quarter 2016 only.

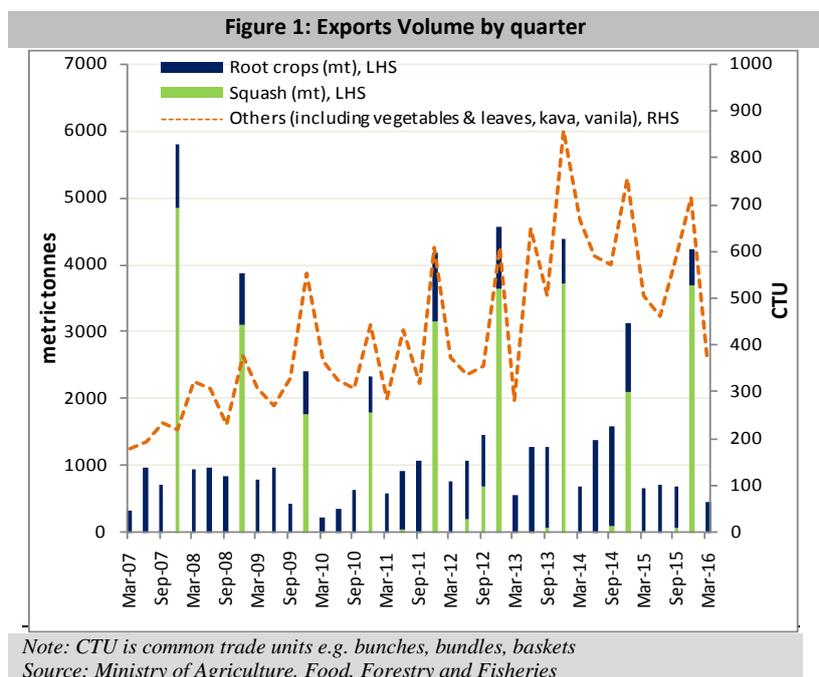
The Official Foreign Reserves recorded at the end of March 2016 were \$317.3 million pa'anga equivalent to 9.0 months of import cover. The outlook, by the NRBT, is for foreign reserves to well remain above the minimum range of 3-4 months of import cover, assuming that remittances and travel receipts increase.

IMF in its World Economic Outlook update – April 2016 projects global growth to be 3.1 percent in 2015, revising down by 2 percentage points from its projections in December 2015. Growth is also forecast to grow at 3.2 percent in 2016 and 3.5 percent in 2017 driven mainly by the emerging markets and developing economies. IMF also projected that the growth of Tonga's main trading partners - Australia, New Zealand and the United States - are expected to increase throughout the forecast period. However, a protracted period of slower growth in Australia and New Zealand could weigh through aid and remittances to Tonga and could lowered demand for Tonga's exports.

REAL SECTOR DEVELOPMENTS

PRIMARY

Activities under primary sector had slowed down over the review period supported by an increase in domestic food prices reflecting lower primary production. The lower agricultural production, for all major products, over the review quarter is more of a seasonality pattern, refer *Figure 1*, and supported by the Tropical Cyclone Winston which contributed to lower agricultural production. This is also consistent with the banking data indicating lower agricultural export proceeds which is also reflecting the end of the squash season.



Proceeds from fisheries exports are assumed to continue to increase over the review quarter contributed by the increase in exports of tuna and snapper in the month of February.

Provisional figures also indicated there was no export of sandalwood over the review quarter compared to previous quarter and same period last year.

Growth for the sector is expected to gradually increase in the coming quarters, for 2015/16 in particular, and onwards as agricultural production is anticipated to recover from drought and back to normal trend. This growth is expected to be supported by various related initiatives to the industry including the improvement in the market access and improving access to Agricultural Marketing Fund, opportunities from the re-opening of European market for kava and continuity diversification of export products to include butter-nut and butter-kin and also the good prices for vanilla has encouraged the increase in production of vanilla.

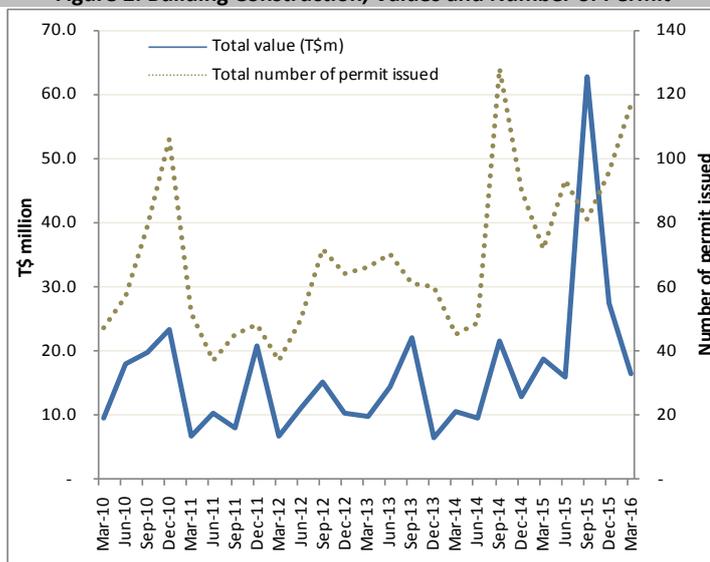
Positive growth that has been forecasted for the fisheries industry for the next quarter and coming years is supported by all related initiatives to the industry including the increase in the shipping capacity for fish exports by more than doubling the number of air cargo shipments per week from the existing (an average of 4-5 tonnes) shipping capacity. Growth of the industry could also be supported from an increase in the utilization of the Fisheries Development and Export Fund even though the impact could be reasonably small.

SECONDARY

Activities under secondary sector remain strong over the review quarter. This was supported by the ongoing construction activities. This is consistent with the increasing in the housing loans and business loans for construction and electricity consumption.

During March 2016 quarter, the preparation for commencement of the upgrading of the domestic wharf (Faua Wharf) was conducted prior it kicked off in April. Despite the decrease in value of building permit issued during the review quarter - lower by 40 percent and 13 percent compared to previous quarter and same period in 2015, construction remains the main driver of growth in the secondary sector through the forecast. This is supported by many construction projects that

Figure 2: Building Construction, Values and Number of Permit



Source: Ministry of Infrastructure

are currently undertaking including the Ha'apai Reconstruction project, Upgrading of Fua'amotu and Lupepau'u airports - runways, renovation of Tanoa Hotel, construction of the government office building, St. George building complex, construction and renovation of school buildings in Toloa and others. The level of import of construction materials is anticipated to increase supported by the increasing number of building permit issued, increase by 27 percent and by over 140 percent compared to previous quarter and the corresponding period a year ago.

Manufacturing and electricity and water supply are both benefitted from the construction activities hence, both sub-sector are anticipated to grow at around their historical average growth rate of 1 percent and 1.8 percent respectively.

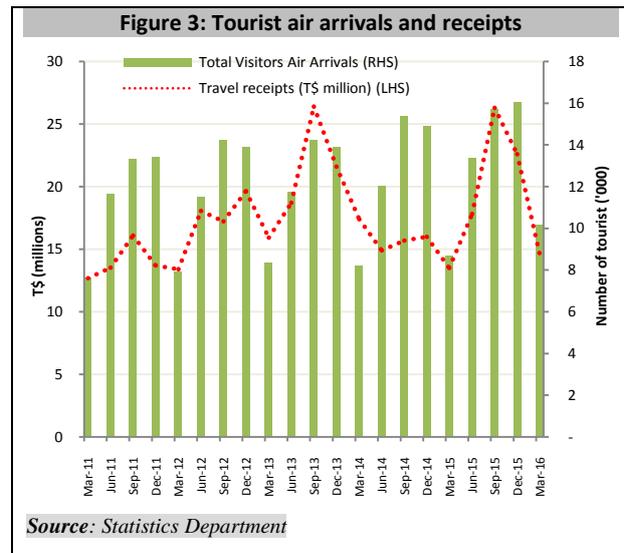
TERTIARY

Developments under tertiary sector are continued to be influenced by the events and celebration effects, tourism related activities and changes to public sector recruitment policies which it has impacted on forecast of growth in government service.

During the review quarter, demand for wholesale and retail goods was less compared to December 2015 quarter. This is consistent with a decrease in the level of import compared to previous quarter however, the level of import for March 2016 quarter is the highest over the same period in the past 10 years. The decrease on quarterly trend was due to bulk of imports were done in the previous quarter as usual, as part of preparations for the Christmas, New Year celebration and prayer week (where number of feasts took place) for Tonga. The level of demand for wholesale and retail goods is anticipated to remain at higher level, as in the preparation for the Coronation, in the next quarter in which the Tupou College 150th

Anniversary in additions to the normal occasions such as church annual conferences take place.

During the review period, activities in the hotels and restaurants subsector were different compared to previous quarter as seasonality, the number of tourist visitors fell due to the end of the holiday season – Christmas and after New Year. This has clearly reflected by the declined, to around \$8 million, in the travel receipts in the March 2016 quarter compared to previous quarter. However, the tourism receipts in the March 2016 quarter exceed the amount in the corresponding quarter in previous year by 8 percent from March 2015. This is associated with an already strong first two



months of the March 2016 quarter. A number of one-off events in addition to major annual events take place in the next quarter and second half of the year such as Tupou College 150th Anniversary, annual church conferences, Heilala Festival and King’s birthday and also the LDS 100th Anniversary, in which some of these events would increase demand for the services of the subsector. While there may be a high level of visitor arrivals during the time of these events and celebrations but the impact of this is expected to be lower as many are likely to be Tongans visiting and might be staying with their relatives and friends. Performance is seen to be mixed in the future; with travel receipts that are likely to continue to decrease, supported by the movement in the value of pa’anga, if it continues to appreciate. Tourist air arrivals are anticipated to increase in the medium term supported by the major events mentioned above including the upcoming Pacific Games in 2019 and other annual activities.

The public administration and services industry is expected to grow strongly during the review period, consistent with the observed increase in the vacancies advertised during the March 2016 quarter. This was in line with the recruitment policy for posts at Level 9A and below in the public service. Growth in the industry is expected to remain relatively low in the outer years if the freeze for further recruitment will be imposed strongly.

There were numbers of developments in the transport and communication industry during the review period. The new direct flight between Fiji and Vava’u became effective during the review period and this has offered a great opportunity not only for the industry but for other sectors as well including tourism. The industry was also supported by an increase in the number of cruise ship arrivals and increase in the number of inter-island ferry, mainly in the first month of the review quarter, as students and employees return back to school and work into Tongatapu after the Christmas and New Year holidays. In addition, the transport industry was also benefitted from the lower fuel prices. Other related projects to the industry are ongoing such as the upgrading of the Fua’amotu airport, upgrading of the domestic (Faua) wharf while some projects such as the extension of fibre optic cable to Vava’u and Ha’apai

and others are still on the pipeline and to be implemented in the next financial year and onwards. These activities helped supporting the growth of the transport and communication sector in the outer years.

RISKS

Further delays and uncertainties in implementation of various major projects post risks to the positive outlook in the medium terms. This is in addition to any further changes in weather patterns.

One of the bigger threats to our positive outlook included the uncertainty whether Tonga will continue to host the Pacific Games in 2019 or not. This event requires a lot of construction activities and yet to commence any physical activities. In relation to growth, delays, scaled back or cancel of such project could cause a weaker growth for the Secondary sector and overall growth throughout the forecast period.

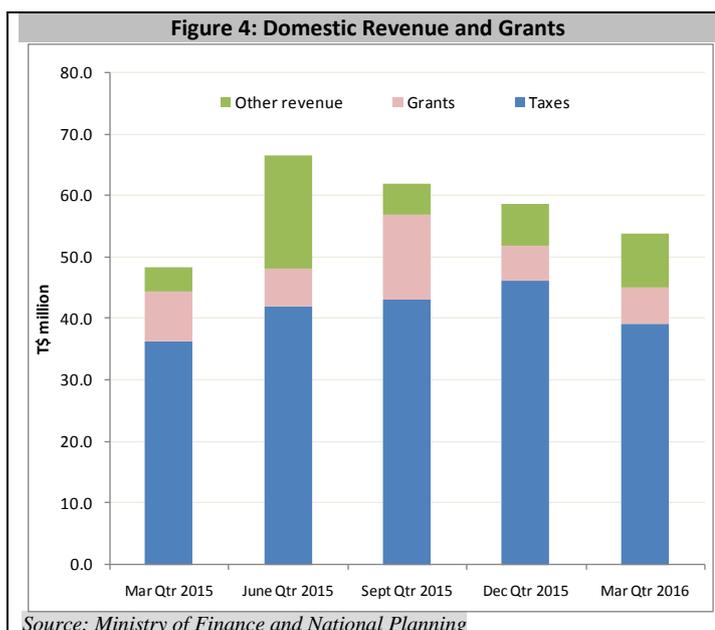
The cyclone or natural disaster season has now passed but if there are still further changes to weather patterns, could increase risks to the agriculture sector and growth for the Primary sector and overall growth anticipated for the forecast period.

Weaker growth in Tonga's main trading partners could posts a risk to Tongan economy. This could affect remittances and demand for Tonga's exports, thus this could lead to a slowdown in domestic activity and slow overall GDP growth.

As expected, global commodity prices are gradually increase towards the end of 2015/16 and Tonga is still remains highly vulnerable to changes in global commodities' prices. Global commodity prices are expected to remain relatively low and in the case for a sharp increase in commodity prices, posting a key risk for Tongan economy. This could lead to an increase in costs of production, raise inflation and might reduce household real incomes.

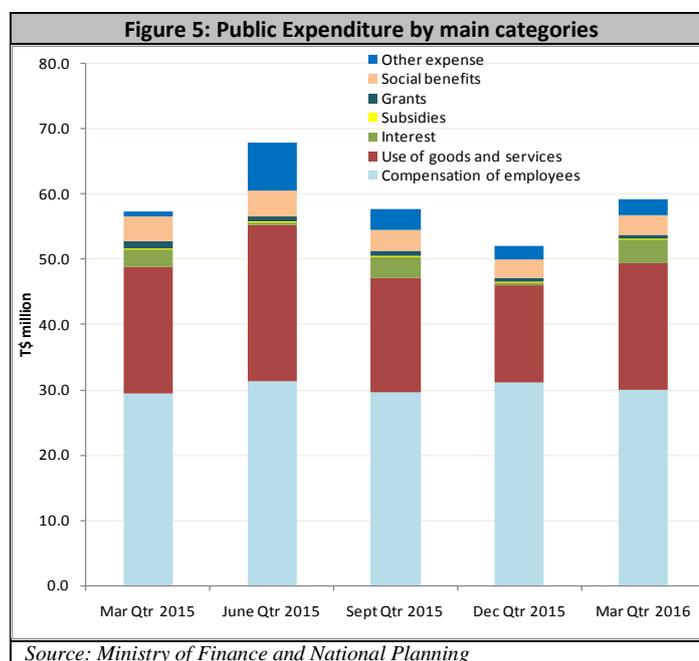
FISCAL SECTOR DEVELOPMENTS

Provisional figures indicated that both domestic revenue and cash grants decreased, by 8%, at the end of March Quarter 2016 compared to previous quarter while increased, by 11%, when compared to same period a year ago. The declined in the quarterly trend reflected the after festive season as shown by a 15% dropped in the collection from tax items supported by lowered collection from motor vehicle taxes, customs and other import duties, CT and excise taxes. The increased on annual basis was supported by 8% increase in the collection from tax



items mainly from PAYE, Corporate Tax from Large businesses, customs and other import duties. This was also supported by the increased from non-revenue items including the receipts of dividends from PEs'. Grants increased over the quarter compared to December quarter was supported by various projects funded by NZ, WB/IDA, SPREP, SPC and many other donors.

Provisional figures for Public Expenditure at the end of the review period was 13.9% and 3.4% higher than both the December quarter 2015 and same period a year ago. The increased in the quarterly trend was supported by the increase in the payment for use of goods and services (by 30.8%) such as electricity, water, telephone, rent etc., interest payment (by over 600%) such as interest for foreign public debt and domestic debt, subsidies (by over 100%), payments for social benefits (10.5%) and other expenses (by 18.3%). The increased on year-on-year basis was supported by the increase in interest payments



(37.5%) for both foreign and domestic public debt, payments for use of goods and services (by 0.3%), a slight increase (by 1.5%) in payment of wages and salaries due to recent 5% COLA implemented in this financial year, as well as other expenses (by over 200%).

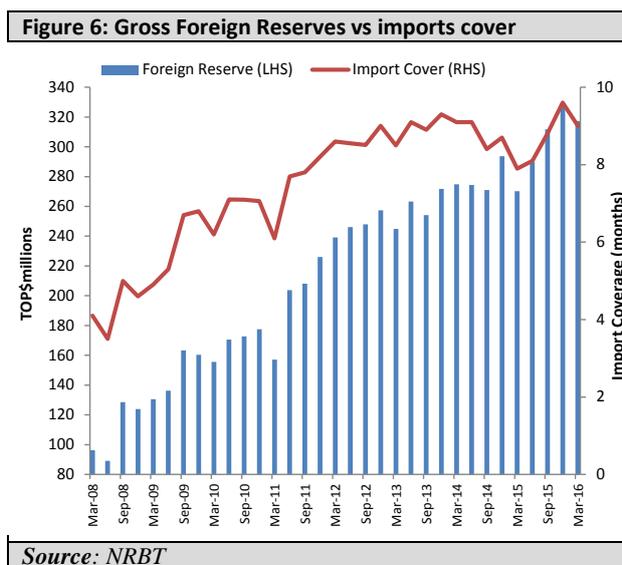
EXTERNAL SECTOR DEVELOPMENTS

Provisional figures for export earnings at the end of March quarter 2016 indicated a decrease (around 17 percent) compared to previous quarter while exceeding the corresponding period in 2015. The decrease on quarterly trend reflected the end of squash season in the previous quarter. Import payments, as indicated by provisional figures for end of March quarter 2016, declined by 19 percent compared to previous quarter while increased by 17 percent over the corresponding period in 2015. More imports of oil during the review period compared to previous quarter due to lower global oil prices as reflected by lower - by average of 16 percent - domestic retail prices of petrol and diesel in the month of March 2016. Imports of food items, intermediate goods and capital goods are expected to be stronger in the next quarter due to events effects raising the demand higher than the review period.

As a result, balance of trade deficit improved when compared to previous quarter but widen to around \$91 million compared to around \$85 million in the same period a year ago.

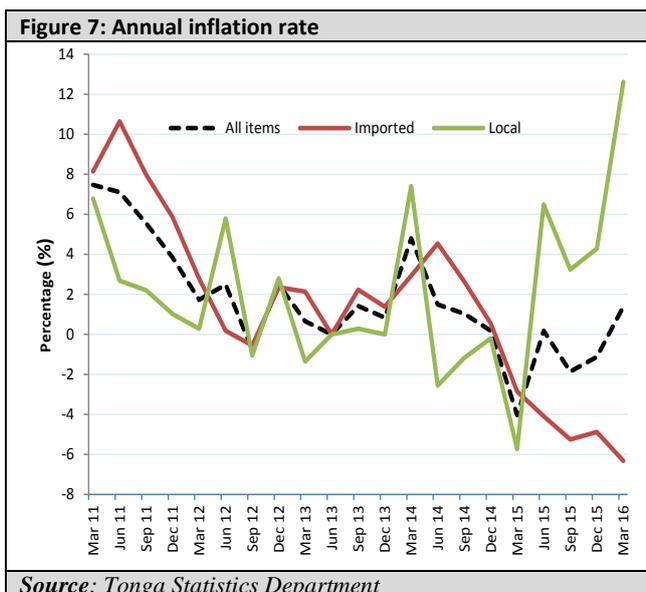
The outlook for the current account of the BOP is for a larger deficit in the next quarter due to the increase in demand for imports associated with the effects of preparation for the Tupou College 150th Anniversary and other events.

The level of gross foreign reserves recorded at the end of March 2016 was \$317.3 million, equivalent to 9.0 months of import coverage. This was lowered by \$10.5 million compared to previous quarter while it was 17% or \$ 47.1 million higher than the same period in 2015. The fall on quarterly basis was mainly due to lower receipts of foreign aid during the review period however it is still sufficient to offset import payments and more than double of the minimum range of 3 – 4 months set by the NRBT.

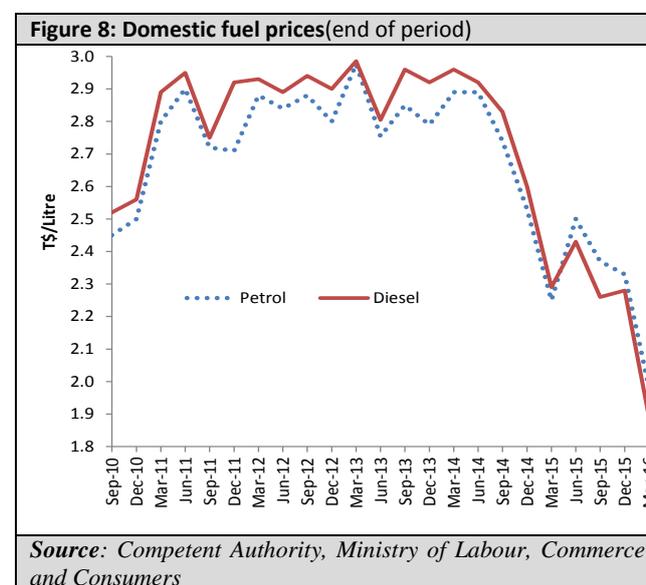


MONETARY AND FINANCIAL SECTOR DEVELOPMENTS

The annual inflation rate at the end of the March 2016 was 1.4% compared to deflation in both the previous quarter (-1.1%) and same period in 2015 (-4.0%). The increase led by 12.6% increase in the price of local items while price for imported items continued with deflation rate. The increase was mainly due to significant increase in prices of kava, fruits & vegetables, meat, fish & poultry. The continued deflation in the price of imported items, under transportation category in particular, reflected the continuous lower global oil price.



Domestic oil prices (both petrol and diesel) have decreased. The declines are due to falls in global oil prices and Singapore refined petrol prices over the quarter, although the depreciation of the pa'anga and higher cost of freight offset some of the price decline. This reflected in lower imported prices for Food and Transportation and Household Operations components of the CPI, down by 3 percent and 8 percent respectively.



Inflation is anticipated to gradually increase through the forecast period if the gradual increase in global oil prices continues, as supply conditions normalize. However, there is still substantial uncertainty about the outlook for global commodity prices following geopolitical risk in the oil producing countries and subdued aggregate demand growth. Changes in the global market could be realized in the domestic market mostly a month after.

At the end of March 2016 quarter, the Pa'anga appreciated slightly against the New Zealand dollar however, slightly depreciated against the Australian dollar and strongly against the US dollar. This movement is due to changes in trading partner economies, with falls in global commodity prices leading to falls in the NZD. The USD has been appreciating as the economy strengthens and the Federal Reserve gets closer to raising interest rates. The Pa'anga has depreciated against the US Dollar from T\$1.99/\$1 in March 2015 to T\$2.24/\$1 at the end of March 2016. If the weakening of the exchange rate continues, it will increase cost of imports and put upward pressure on inflation. The depreciation in Pa'anga, in the case of US dollar as well as Australian dollar, benefits the remittances recipients in Tonga while it is not in the case for New Zealand dollars.

