



MINISTRY OF FINANCE & NATIONAL PLANNING

HALF-YEARLY ECONOMIC REVIEW 2016/17

(July-December 2016)

**ECONOMIC ANALYSIS
NATIONAL PLANNING AND ECONOMIC DEVELOPMENT DIVISION
MINISTRY OF FINANCE AND NATIONAL PLANNING
GOVERNMENT OF TONGA**

January 2017

Notes

a) The following definitions are used in the Half-Yearly Economic Update (HYEU):

- 'Real' means adjusted for the effect of inflation.
- Real Gross Domestic Products (GDP) and Nominal GDP are linked through a measure of the price level.
- 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.; FY2017 ends on 30 June 2017.
- Forecast period refers to 2015/16 – 2019/20.

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:

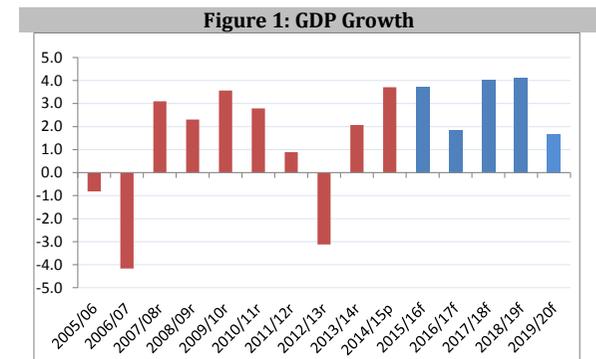
AUD	Australian Dollars
CT	Consumption Tax
GDP	Gross Domestic Product
EU	European Union
IMF	International Monetary Fund
MT	Metric Tonnes
MTO	Money Transfer Operators
NRBT	National Reserve Bank of Tonga
NZD	New Zealand Dollars
OET	Overseas Exchange Transactions
PAYE	Pay As You Earn
TASP	Tonga Agriculture Sector Plan
TSDF II	Tonga Strategic Development Framework 2015-2025
UK	United Kingdom
USA	United States of America
USD	United States' Dollars
WEO	World Economic Outlook

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OVERVIEW OF THE ECONOMIC PERFORMANCE, OUTLOOK AND HIGHLIGHTS

- Global economy economic growth is projected to be at 3.4 percent and 3.6 percent for 2017 and 2018 respectively. This strengthening is primarily led by the pick-up in the emerging market economies.
- The Asian and the Pacific region will remain strong. The pick-up in the global economy will support exports of the Asian economy.
- Growth momentum in the economy picked up during the first half of FY2017. Moderate improvements were recorded in the main sectors such as agriculture, construction, and financial services, fuelling expansion in domestic demand. However, the economic growth forecast for the FY2017 has been revised downward from 2.7 percent forecasted in the Budget Statement 2016/17 to 1.9 percent. Significant increases were recorded in domestic demand in 2016 as a result of the Tupou College 150th Anniversary. The continuous improvement in the financial sector has continued to support domestic demand. Now the construction activities for the 2019 Pacific Games initially planned for 2015/16 and 2016/17 are likely to occur in FY 2018 due to negotiations been longer than anticipated. The strong recovery from drought in earlier years have also been witnessed in the agricultural sector.
- On the external front, notable improvements in the remittances from Tongans overseas continue to drive the growth in foreign reserves. Favourable economic conditions in the US, Australia and New Zealand will be key in driving this growth in outer years. Total exports of agricultural product staged a modest pick-up in the first half of FY2017, mainly as a result of increases in the export of root crops. On the flip side moreover, import has continued to outpace export; hence the widening trade deficit.
- Inflation slightly decline in October to 6.1. This remains significantly high when compared to the deflation of 1.3 percent recorded in October 2015.
- The one-off event of the Tupou College 150th Anniversary that was marked in June 2016 has a cross cutting impact on other key sectors. With the completion of this event, rest of other sectors slowed down to their normal trend. This is one of the assumptions that direct the forecasting exercise for 2015/16 and 2016/17.
- Economic growth in forward years are expected to maintain a much higher growth at an average growth of 3.3 with bulk of the constructions of sport facilities. The economic growth for FY 2017/18 is projected to be at 4 percent. The main drivers is the starting of the preparation for the Pacific Games. The construction sector lead the growth with a 13.8 percent. The upgrading of the Teufaiva Stadium will have a direct impact on other sectors such as mining and quarrying sector, the electricity and water and wholesale and retails.
- Economic growth projected for 2018/19 is also at 4.1 percent. The pattern of growth is more or less the same with the FY 2017/18. This is the second year of preparation for sport.
- Upcoming 2019 Pacific Games also plays an important role in terms of forecasting. This event is expected to spur heightened activities in different sectors of the economy in addition to construction. The upgrade of the Teufaiva stadium, the building of a swimming pool, the building of accommodation and the golf course will have an impact on electricity and water, mining sector, hotel and restaurants, wholesale and retail as there will lots of goods need for the construction. These constructions will hopefully create employments and will in return support domestic demand.
- Level of foreign reserves at the end of December 2016 was \$379.0 million. Import cover remains at an average of 9.3 months.
- Travel receipts decreased by 22 percent in the July–December 2016 period; from T\$48.9 million in the same period in 2015.



Sources: Statistics Department and Ministry of Finance and National Planning

- The potential risks that could affect economic activities and growth in Tonga include bad weather conditions and natural disasters, significant delays in implementation of projects, scale-back or cancellation of donor-funded public construction projects and external shocks.

GLOBAL ECONOMY

The IMF, in their World Economic Outlook, projected the economic activity for 2017 and 2018 to pick up after a mixed performance in 2016. Global economy is now estimated at 3.1 percent for 2016. The global economic growth is forecasted to accelerate in 2017 and 2018 by 3.4 percent and 3.6 percent respectively. Both advanced economies and emerging market and developing economies (EMDE) is forecast to accelerate also in 2017-2018. Among those strong growth economies, economic activity in the US rebounded strongly in the first half of 2016 and will maintain that pace for 2017 and 2018 with 2.7 and 2.5 percent respectively. The economic growth projections for Germany, Japan, Spain and the United Kingdom have also been revised upwards. This upward revisions is basically depend on the recent pick up in the second half of 2016.

The strengthening in the global economic outlook for 2017 and 2018 is primarily on the projected pick-up in the EMDE's growth. The EMDE's growth is currently estimated at 4.1 percent for 2016. The outlook for 2017 is to reach 4.5 percent. This outlook is 1 percent lower.

REGIONAL ECONOMY

The Asia and Pacific region is expected to continue to be the fastest-growing region of the world economy in 2017. The near term outlook remains strong helped by a stronger global economy and broadly accommodative policies and financial conditions. The GDP growth is forecast to reach 5.4 percent in 2016 and 5.3 in 2017 by the IMF. The global recovery is expected to support Asia's export growth while strong credit growth and relatively low interest rates will sustain domestic demand.

China's GDP growth is projected to remain strong. The risk of China's hard landing in the next 2 or 3 years remains a key risk scenario, with the rest of the Asia and Pacific region particularly vulnerable to such a shock. Further to the US Federal rates hike in 2017 may cause some turbulence in global financial markets and result in the US dollar appreciating further against many Asian currencies. The risk of rising trade tensions between the US and China is another key risk. Other big economies in the region are projected to have mixed growth as some economies have been affected by volatility in the financial markets.

The Inflation outlook remains largely benign. The headline inflation is projected to rise.

DOMESTIC ECONOMY

Growth momentum in the domestic economy continues to pick up during the first half of FY2017. The economic growth forecast for the FY2017 has been revised downward from 2.7 percent forecasted in the Budget Statement 2016/17 to 1.9 percent. The revised estimate for economic growth is due to changes of plan for the preparation for sports. The construction activities for the 2019 Pacific Games initially planned for 2015/16 and 2016/17 are likely to occur in FY 2018 due to negotiations been longer than anticipated. However, moderate improvements were recorded in the main sectors such as agriculture, construction, and financial services, fuelling expansion in domestic demand. The continuous improvement in the financial sector has continued to support domestic demand. The strong recovery from drought in earlier years have also been witnessed in the agricultural sector.

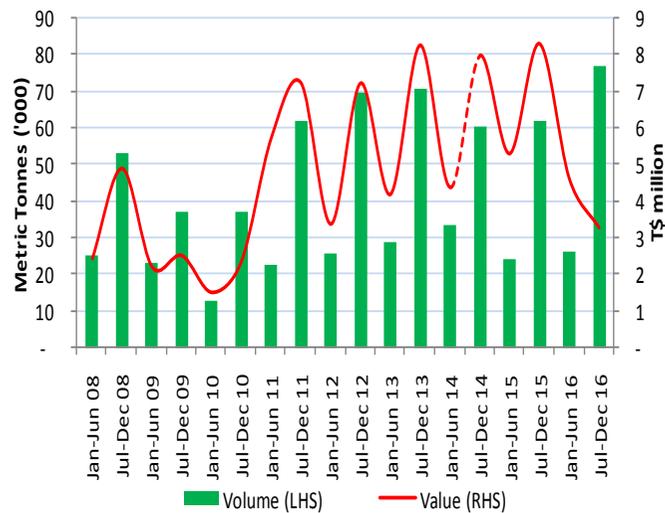
The economic growth for FY 2018 has improved to 4 percent from 3.8 percent forecast in the Budget Statement 2016/17. This is due to the shift of the implementation of all projects for sport from 2016/17 to 2017/18. Other sectors are affected by this change of plan. Mining and Quarrying are supported by this improvement in the construction sector. Electricity and Water, Manufacturing and wholesale and retails are assumed to follow.

The same pattern of growth is assumed for FY 2019. Construction sector take the lead and the rest of the sectors follows. Close to the end of the financial year, transport sector will start pick as team for sports start arriving. Hotel and restaurants will of course assumed to pick up. Wholesale and retail is projected to improve as more goods need to meet the increasing demand.

REAL SECTOR DEVELOPMENT

AGRICULTURE

Figure 2: Agricultural Exports



Sources: Statistics Department & MAFF (Quarantine Division)

The first half of FY2017 recorded an encouraging performance in the agricultural sector compared to previous 6 months. Almost all agricultural products recorded huge improvements in exports compared to the weaker recovery from previous year's drought in FY2016. However, few products show mixed results due to the seasonality in export markets.

Export of root crops upended by about 190 percent in tonnage. This was driven largely by an increase in the export of cassava by 221 percent to around 2.19million metric tons in September 2016. Again this huge pick up was dominated by an increase of around 800 percent in tons of cassava exported from the Vava'u wharf. Export of other root crops, such as Kape or Giant Taro rose by 204 percent (0.15 million metric tons) in the first half of FY2017. Around 70 percent of kape left from the Vava'u wharf. Export of Yams also picked up by 36 percent from previous 6 months; to 0.8 million tons. Sweet potato moreover seem to lose some momentum; export dropped by 6 percent to only 94,000 tons. Handicrafts export also increased by about 80 percent compared to the previous 6 months, Kava exports on the other hand dropped by 70 percent compared to same period in FY2016. This might have been caused by domestic supply constraints.

In comparing the first half of FY 2017 to the same period of FY 2016, agricultural exports have increased by 17 percent to 7.3 million tons of exports. Root crops have shown a huge improvement by 166 percent from the same period of last financial year which was affected by drought. Other products also show an improvement in terms of exports.

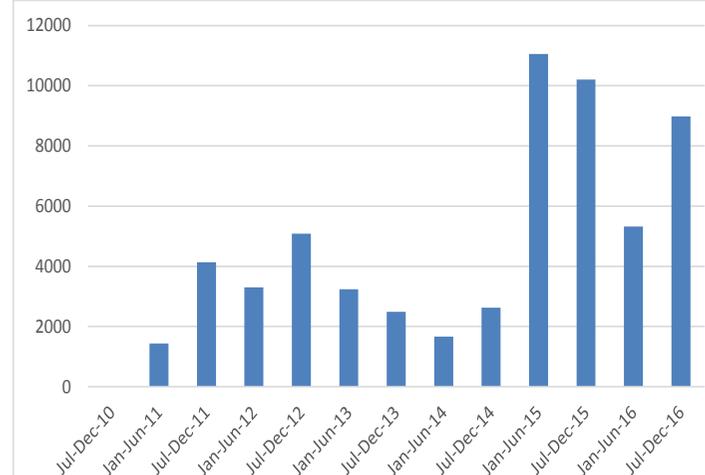
Squash exports for the first half of FY 2017 was dropped by 27 percent to 2.76 tons of export compared to the previous squash season. This is due to the low rainfall in September & October 2016. There was also negotiation issues between exporters and overseas market which affect the export of squash.

The outlook for the industry is positive. This is strongly supported by ongoing initiatives aimed at improvements in market access and diversification of export products to include butternut and butter-kin, vanilla and coconut. Furthermore, enhanced access to Agricultural Marketing Fund would help to support the level of activity of the sector.

Over the medium term, average growth of 2.2 percent is projected for the sector. There remain emerging issues for consideration by stakeholders in order to improve performance of the sector. The consistency in the supply of agricultural products to the overseas market is also a critical factor to consider in the development of this sector. For instance, the need for re-planting of kava to guarantee sustained future supply of export markets has been raised in a number of quarters. However it normally takes about 3-5 years for kava to be well matured prior to harvesting. Hence, the earlier action is taken in this regard, the better for future export. In addition, there is need for continuous training of extension workers and farmers to improve the capacity of the sector to adapt to changing climatic conditions including drought and El Nino weather conditions.

FISHERIES

Figure 3: Fisheries Exports Value (T'000)



Source: Ministry of Agricultural, Food, Forestry and Fisheries

Fisheries subsector is estimated to continue at its positive but moderate trend throughout the first half of the FY2017.

The available data indicates that the volume of marine export¹ in the first half of FY 2017 increased by 30 percent to 1,371 metric tons compared to same period in FY 2016. This improvement was led by a 96 percent increase in Tuna export to 1,810 tons. The export of Snapper increased by 64 percent to 80.91 tons in the first half of FY 2017; that of Shark meat also rose by around 800 percent to 69 tons over the same period of FY 2016. In terms of value, it dropped by 20 percent when comparing to the same period in FY 2016.

The aquarium² exports fell by 95.6 percent in the first half of FY 2017 to only 53,955 pieces compared to the same period in FY 2016. The value of export in the review period dropped by 27 percent and this is due to drop in global commodity prices.

The increase in number of local fishing vessels from 2 to 4 has been major contributing factor to fisheries sector performance during the review period. The expansion of cargo capacity is

part of the administrative reforms being undertaken by the Ministry of Fisheries to boost growth prospects of the sector.

In terms of value of fish (both aquarium and marine) export, value of export in the first half of FY 2017 declines by 20.5 percent compared to the same period of FY 2016. This is due to the depreciation of the pa'anga against the US and in addition to drop in exports volume of aquarium products by 95.6 percent to around 54,000 pieces.

The growth of the Fisheries industry was very volatile due to weather and sea conditions, market conditions, fish migration, poor infrastructure and other factors. However, the provision of the Fisheries Development & Export Fund Loans assisted the sector even though its impact on GDP remains relatively small.

Over the medium term a very positive outlook for the primary sector is expected with an average growth rate of 2.2 percent. There are various initiatives ranging from financial leverage to non-financial support that would have positive impacts on the primary sector as a whole and fisheries sector in particular. Government is continuing its support through the Government Development Fund with lower interest rate. The ongoing subsidies through waiver of duties and CT on import of raw materials that are used in production is expected to spur further growth of the sector. The current trade negotiations on improved market access to our products will also have positive impacts. On the downside, the ongoing struggle over Tu'imatamoana wharf can divert the current effort of fishermen.

FORESTRY

The Forestry sector is expected to continue its expansion through additional planting of sandalwood and timber woods. These are sources of income for households. Exports of sandalwood have been on and off due to unstable supply; sustained planting will help mitigate this in near future. Timber woods on the other hand are in high demand in the domestic market for construction and electricity poles. Export supply of Timber woods will also get a boost from additional planting. The foreign investment on Tonga Forest will support the growth of this sector in the forecast years. The average growth of 0.3 percent is forecasted for outer years. The ongoing supply of seeds by the Forestry Division of the MAFFF help secure the future of this sector.

¹Marine exports refers to Shark meat, Tuna, Snapper, Seaweed, Beche de mer and other products which also refers to live crustaceans and reef fish)

²Aquarium refers to Invertebrates, Live hard coral, live rock, live fish, Shellfish and Soft Coral.

MANUFACTURING

Manufacturing sector grew at an average rate of 0.5 percent over the decade to 2015/16. Positive growth of 0.8 percent is projected for the sector for FY2017 and an average of 1.4 percent onwards. This is in line with good performance in CT returns which increased by 21.5 percent over the six months period compared to CT return recorded for January to June 2016. We assume that the increase in CT returns is also accompanied by an increase in CT paid from manufacturing businesses. However, the collection may continue to be successful if enforcement and compliance are well implemented. Part of the manufacturing products are supplied to the strong growth sector of construction.

CONSTRUCTION

Growth in construction is expected to strengthen further in FY2017 due to expected increases in both public and private construction. The outlook for construction sector is positive and anticipated to continue to grow stronger in the outer years based on current and planned projects. The ongoing public projects are upgrading of Fua Wharf, and the St. George's building complex. The 2019 Pacific Games related projects such as the construction of a golf course and an Olympic-sized swimming pool and upgrading of the Teufaiva stadium are expected to commence in late 2017. This is also supported by the continued strength in total imports of construction materials. Other large public (donor-funded) construction projects include the Ha'apai reconstruction project, resurfacing of Fua'amotu and Lupepau'u airport (PAIP), utilities network upgrades and the cable connection between Tongatapu and Fiji. This strengthening is well in line and consistent with the profile of projects included in our public construction forecast for FY2017.

The value for private construction has increase by 31 percent over the month of October 2016. The total bank lending rose by 1.5 percent to \$368.2 million in October 2016 which was led by the increases in all household lending with a contribution of 2.1 percent to a new record of \$203.8 million with bulk of this loan goes to house construction. The number of building permits issued in the review period was also higher, by 7 percent, than in the previous six months. The increase in private construction was also supported by the lowest average of interest rate, 8.5 percent, recorded for 2015 since 2008, for housing loans.

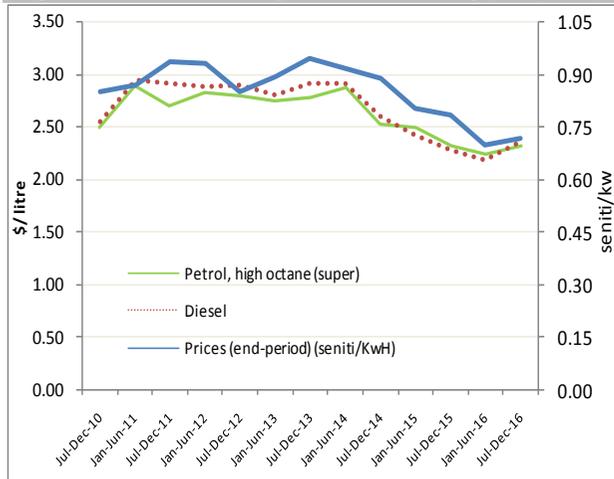
Further delays in the construction projects due to various reasons including resources or funding constraints and land issues remain the most challenging factor and pose high risk to the projections for the construction sector. Scale back or further delays of projects would cause weak performance for the sector in the near term.

Growth for mining and quarrying sub-sector is assumed to move along with the growth from construction activities.

Going forward to the outer years, this is the leading sector with an average growth rate of 8.3. The upgrade of Teufaiva stadium is scheduled to start in FY 2018. The construction of the swimming pool and the gold course are also planned to start in the next financial year. Other sector are projected to be supported by the growth in construction sector. The quarrying sector is projected with a huge increase by 35.8 percent. Whole sale and retail is also projected to response with tons of imports for the construction. FY 2019 is expected to adopt the same growth pattern.

ELECTRICITY

Figure 4: Domestic fuel prices & electricity (end period)



Sources: Competent Authority (MCTL) & Tonga Power Ltd

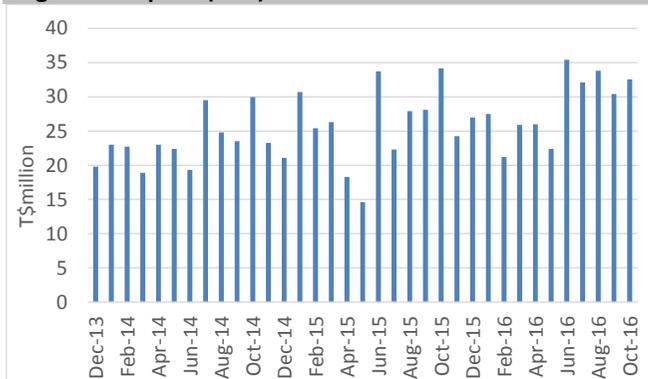
The retail prices per liter for petrol and diesel at the end of period (Jul-Dec 2016) was 2.33 and 2.37 pa'anga per liter respectively. This price of petrol remains the same while price of diesel rose by 9 seniti compare to the same period in previous year. This current trend of fuel prices has remained low. This has allowed the fuel component of power tariff to remain at manageable thereby assisting households reduced spending on electricity during the hot season. This also serves as a boost to higher demand for electricity in Tonga. The electricity price for October 2016 was 74 seniti per kilowatt which is lower by 7 seniti compare to 81 seniti per kilowatt recorded in October 2015.

Continuing lower electricity price per unit is also anticipated to given the drive towards a green economy with more reliance on solar energy and others. The construction of additional solar farms in the country are part of ongoing public projects.

This is another sector that also relates to the growth in construction sector as every new building must have electricity and water during the construction and must have during the construction period and after completion.

WHOLESALE AND RETAIL TRADE

Figure 5: Imports(OET)



Sources: National Reserve Bank of Tonga

Wholesale and retail trade sector is estimated to have slowed down to 0.3 percent in FY2017. This fall back in the growth rate to pre-2015 level marked the completion of the one off event of the Tupou College 150th Anniversary which boosts the demand for imports.

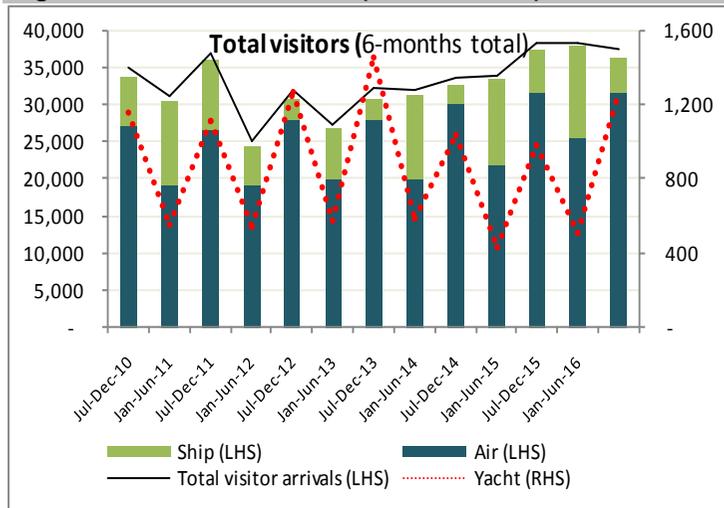
Imports, as October 2016 was recorded at 32.6 million on OET basis. This is lower by 1.6 million compared to the level of imports in October 2015. The outlook is positive as import is estimated to recover given upsurge in remittances and public projects that will fuel more domestic demand for foreign goods.

HOTELS AND RESTAURANTS

Output in the Hotel and Restaurants sector is forecasted to have dropped in FY2017 after the end of two consecutive big events—the Coronation in 2015 and Tupou College 150th Anniversary in 2016. The amount of travel receipts recorded in the first half of FY2017 fell by 22 percent compared to same period in FY2016. However, the amount of travel receipts increased by 6percent in July-December 2016when compared to the second half of FY2016.

Tourist arrival for the 6 months up to December 2016 declined slightly compared to previous six months and same period in FY2016. The number of Tourists who arrived by ships declined while those that arrived on yacht and airplane increased. The school anniversary of Kelana and Kolonga day has brought more Tongans living abroad to live and meet with their relatives.

Figure 6: Total Visitors Arrivals (6-months total)



Sources: Competent Authority (MCTL) & Tonga Power Ltd

Outlook for the sector is also positive as arrangements are being finalized with Tour operators for more cruise ships to be arriving in Tonga in the medium term. The Government Development Loan Fund has also provided financial assistance to local tour operators and owners of small to medium sized hotels and restaurant. Although, the loan fund remains relatively small to the size of the sector, the continued provision of the government concessional loans along with improved coordination within the tourism sector would help to maintain the performance of the sector in the future. The concessional loan provided to the sector is aimed at promoting the development of new tourism products, improve the quality of small-medium accommodations, help the development of a clean and beautiful tourist environment, and assist in the development of heritage sites and cultural events.

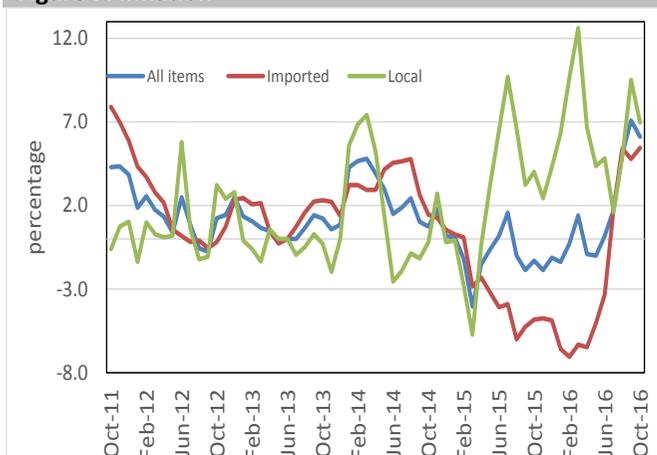
TRANSPORTATION & COMMUNICATION

Strengthening in growth of the sector in FY2017 is strongly supported by the decline in fuel prices as well as the increase in number of vehicles registered and increase in activities of other sectors. All these led to added impetus to the GDP. The demand for land transport services was also higher through this period. The transport industry is also being supported by increases in construction activity, including the need to transport construction materials to outer islands and Ha'apai for ongoing reconstruction projects. Positive growth is anticipated for international shipping services, in line with the increase in number of cruise ships that visited the Kingdom. The proposed upgrading of Fuaa wharf will help to improve the capacity of the wharf to accommodate further increases in domestic and international shipping services.

The ongoing active competition between the two domestic telecommunication operators had benefitted the sector, which was well also assisted by the fiber optic cable, and have resulted in increasing usage, cheaper prices, coverage and more promotions offered to their customers despite the small size of the market. The extension of the fiber optic cable to outer islands such as Vava'u and Ha'apai should also support the performance of the communications sector in the future.

INFLATION

Figure 7: Inflation



Sources: Statistics Department

The annual inflation as at October 2016 was 6.1 percent. This falls from the 7.1 percent recorded in September 2016. These however remained significantly high when compared to the deflation of 1.3 percent recorded in October 2015.

This inflation rate is higher than the inflation target of 2-5% set by the NRBT and calls for policy intervention. The continuous record of high inflation rate still results from a combination of possible factors ranging from increasing prices of global commodities, effects of the new excise tax on meat and poultry and supply constraints for kava. The depreciation of Tongan pa'anga against AUD and NZD which led to increase in prices of some imported meat and other imported items, is also a factor.

Annual changes in the CPI for the first half of FY 2017 were mainly driven by increase in the price indices of both local and imported items. Changes in the domestic price index is led by increase in the price of Kava by more than 150 percent while that of the imported index is led by the price of Meat, Fish and Vegetable products that rose by 12 percent.

EXTERNAL DEVELOPMENTS

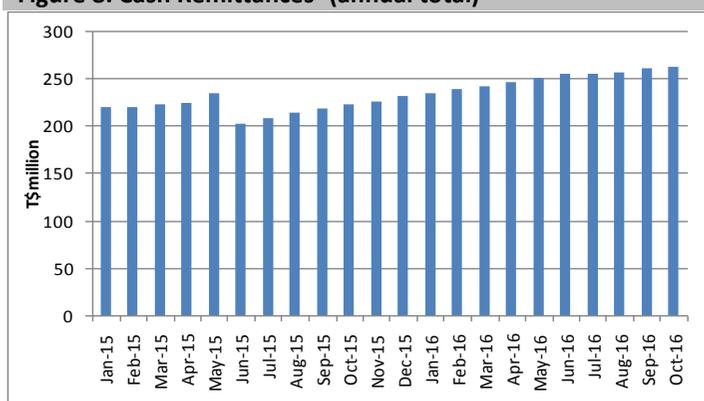
The trade balance (OET) recorded for October 2016 was a deficit of 30.45 million. The trade deficit increased over October by 7 percent. However it is recorded to have improved over a year ago by 8 percent. Trade deficit has been fluctuating over the last twelve months.

Exports (OET) was only 2.10 million compared to the imports of 32.6 million. The October export was the same as the total exports in September. The estimated amount of exports for rest of the months for 2016 is estimated to fall due to seasonality of crops that are exporting.

Import (OET) increases by 7 percent over October. Over a year ago, import fell by 4.7 percent. The outlook for the rest of the months of 2016, import will rise to cater for the Christmas season of families sending back goods to the relatives still in Tonga.

CASH REMITTANCES

Figure 8: Cash Remittances³ (annual total)



Source: National Reserve Bank of Tonga

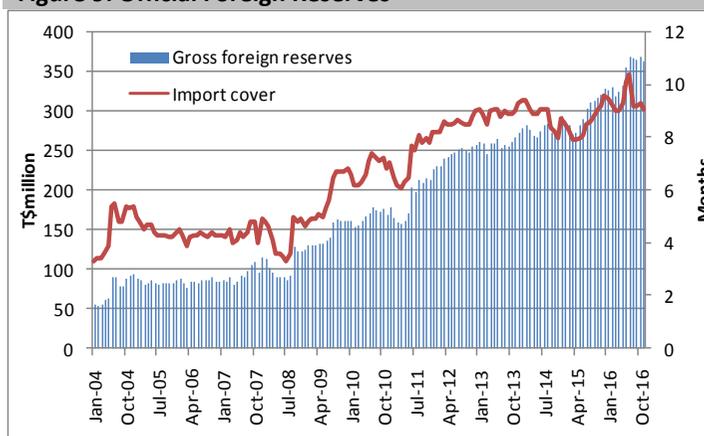
As at October 2016, level of remittances reached T\$263 million. This is 2.7 percent higher than the level of remittances recorded in June 2016 and 18percent higher than the level recorded in October 2015.

The total cash remittances for the review period July-Oct 2016, are expected to continue to remain at high levels due to the holiday festive seasons - Christmas and the New Year holidays.

Remittances are anticipated to remain fairly strong supported by increasing number of seasonal workers overseas and continuing strong relationship between overseas Tongans and relatives in Tonga.

FOREIGN RESERVES

Figure 9: Official Foreign Reserves



Source: National Reserve Bank of Tonga

Official foreign reserves held by the National Reserve Bank (NRBT) remain high at T\$379.0million in December 2016. This is higher by T\$24.1 million and T\$51.2 million than the previous level of reserves at the end June 2016 and level of reserve at the end of December 2015 respectively. This level of reserves in December 2016 is equivalent to 9.8months of import cover.

³ In the NRBT's Remittances Report for April 2015, it stressed out the recent change made in its methodology used, aiming to further improve measuring of the foreign exchange transactions in Tonga, following Tonga's transition into Balance of Payments and International Investment Position Manual 6 (BPM6), endorsed by the IMF. Previously, Remittances were calculated as sum of Personal transfers and Non-profit Organization transfers. The removal of these Non-profit Organization transfers from the calculation, despite the addition of three other receipt types, has resulted in a lower Total Remittance Receipts figure under the new methodology. Numbers for Jan-March 2015 has been revised also.

MONEY SUPPLY AND BANKING SECTOR

The low interest rate environment in the financial sector continued in the first half of FY2017. Weighted lending interest rates are at historic lows. This low rate has contributed to the upward trend in credits to the private sector, a trend that started in the first half of FY2015. The weighted lending rate recorded at the end of November 2016 was 7.91. The weighted deposit rate for November 2016 was 2.26. These two rates in October 2016 compared to 7.22 recorded at the end of October 2015.

Broad money rose by 1 percent over October to reach \$501.2 million to set a new high record. 16.9 percent over the year 2016 to \$501.2 million. This results from an increase in the net foreign assets and net domestic assets.

The bank lending rose by 1.5 percent to \$368.2 million in October 2016 to the private sector in June 2016 is still below the level where it was in 2008 before the crisis hit.

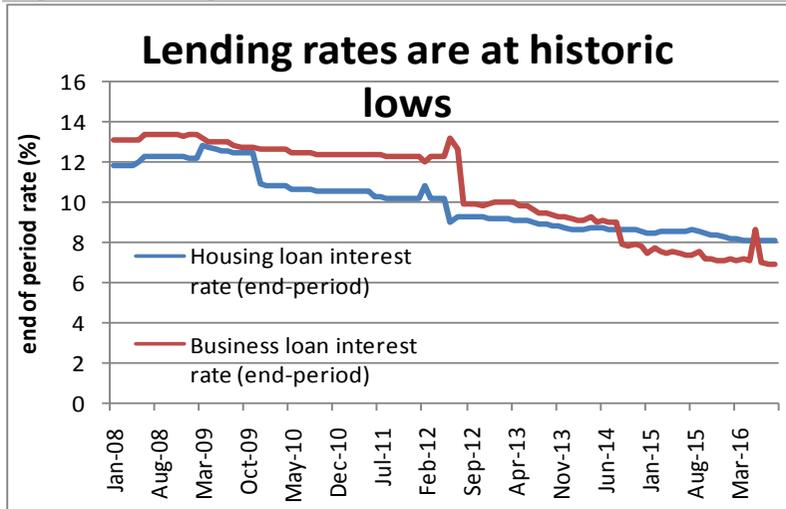
Deposits rate remain at a very low level. This has reflected the amount of liquidity available in the financial sector which drives the prices of deposit to fall.

Figure 10: Domestic Credit



Source: National Reserve Bank of Tonga

Figure 11: Lending rates



Source: National Reserve Bank of Tonga

RISKS

The economic activity and outlook for Tonga is still remaining vulnerable subject to various potential risk factors. Our forecast for the primary sector remains highly vulnerable to weather conditions and other administrative issues that continues to affect this sector. Due to El Nino weather pattern which increases the risk of drought, and may also increase cyclone risks. Another period of drought would again limit or further reduce production in the agriculture sector and reduce GDP growth below what is currently forecast, 2.5 percent, for 2015/16 and 2 percent for 2016/17. The squash industry continues to suffer from administrative issues in the first half of FY 2017 and need a policy intervention to minimize the future risk.

Weaker growth for the Secondary sector could be experienced if there are uncertainty and significant delays to donor-funded public construction projects, including the 2019 Pacific Games and other projects in the pipeline. While these delays would create weaker growth in the near term, growth in subsequent years may be stronger.

Since Tonga is a small economy, and it is heavily rely on imported goods. The cost of imported goods would possibly rise with increases in commodity prices and with further depreciation of the pa'anga as well as other factors. However, if the US dollar continues to appreciate it will cause higher cost for imports and contribute to a rise in the imported component of inflation, particularly through higher fuel and electricity prices. Another drought or any damage caused by a natural disaster could tend to increase the domestic inflation. The pressure on oil prices to rise also put another threat to the cost of imports as well as other economic activities that depends on fossil fuel.

The economic conditions of Tonga's main trading partners (Australia, New Zealand and the United States of America) also plays a critical role since Tonga is heavily dependent on, remittances and market for export. If their economic conditions becomes weaker it would have resulted in a slowdown domestic activity and overall GDP. The IMF reported a strong rebound in the US economy during the first half of FY 2017. They also projects growth in the US at 2.3 percent for 2017 and 2.5 percent its projection for 2018. Growth in Australia and New Zealand are also expected to continue to improve. These forecast are stated to be two sided and the assessment over the medium term that it will be skewed to the downside. The future impact of the current development on political, banking sector and trade could lead to permanently lower growth with negative implications.

The most challenging exercise in the forecast is to deal with the indicative figures on projects for outer years. There are projects with confirmed funding and lots of unconfirmed funding. There are projects that are already in the pipeline and there are lots of projects that are yet to have a feasibility studies. There are projects that have completed feasibility studies but still have not had a project proposal. So these different stages of projects provide a very challenging exercise of dealing with them.

CONCLUSIONS AND POLICY ISSUES.

The economic development for Tonga has been recently improved. The global economy has been very supportive following the ongoing support of the Tongan major trading partners. This is being reflected in various sectors such as wholesale and retail, hotels and restaurant and the construction sector. The preparation for the Pacific Games 2019 also plays a critical factor on growth and this has also been reflected in the economic forecast as has been shift to start in FY 2018. With the starting date of the preparation being shift to FY 2018, the preparation will left with only 2 years to complete all the building facilities before the game start.

The credit growth is growing fuelling domestic demand. The trade although is still on deficits but looks promising with the ongoing negotiations and arrangement to improve exports. These has provide a more stable macroeconomic foundation for the economy for the near medium term.

In the medium term, the projected growth rate for 2019/20 is 1.7 percent. The slower growth marked the completion of the construction for the sports. There are public projects that comes in 2019/20 but yet to confirm. The spillover effect of sports contribute to this growth projection as there are high expectations that the spillover effects can mitigate the drop in the construction.

While the near-term outlook for Asia and Pacific remains strong, there remains the need for accommodative policies to maintain financial conditions that underpin domestic demand so as not to trigger weak export growth. These situations call for relevant authorities in Tonga to be vigilant of the implications on the domestic economy. Accommodative and growth enhancing fiscal and monetary policies, effective implementation of programs and projects, close monitoring of the TSDF II outcomes, as well as the medium term expenditure framework and debt strategy will be key in maintaining current growth momentum for the country. Furthermore, for Tonga to sustain the level of budget support from development partners and achieve desired growth trajectories for sustainable economic and social development, collective efforts from government and stakeholders in the economy must continue to comply with set conditions.

The current government efforts to support private sectors will continue to stimulate the growth and at the same time need to closely monitor the performance of these initiatives for a longer term results.

In addition, there is also need to come up with fiscal and monetary policy measures to dampen the inflationary pressure coming from Kava, oil prices and imported goods. There is also need for policy framework to support investors to attract tourist and enhance private consumption expenditure and maintain gross reserves at the current level to strengthen resilience to shocks. A sound policy to promote technical and vocational training and education as well as improved productivity of seasonal workers would help speed up achievement of the goals of sustained levels of employment, hardship and poverty.

Furthermore, a set of fiscal rules should be in place to provide a consistent guide to annual fiscal policy making in an inherently volatile environment. Such fiscal anchors, which would consist of a set of quantified benchmarks for key fiscal aggregates, would aim to reflect critical policy objectives of maintaining aggregate fiscal sustainability, revenue mobilization and wage bill affordability, and provide a clear and transparent mechanism for communicating these objectives across government and to the public.