



Ministry of Finance and National Planning

**Quarterly Economic Update
(QEU)**

MARCH 2018 QEU

March 2018



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TONGA*

Notes

- a) The following definitions are used in the Quarterly Economic Update (QEU):
- '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 2016/17 – 2020/21.
- b) Figures in the tables and text have been rounded. Discrepancies in tables between totals and sums of components are due to rounding.
- c) Fiscal data used in this QEU are still provisional and subject to change.
- d) The methodology for calculation of months for import cover has changed in February 2017 to include both imports of goods & services, as previous method use imports of goods only. The revision has back dated to September 2015.
- e) 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)
- f) The following acronyms referred to as:
- | | |
|---------|---|
| ADB | Asian Development Bank |
| AUD | Australian Dollars |
| BOP | Balance of Payment |
| CT | Consumption Tax |
| EMDE | Emerging Markets and Developing Economies |
| GDP | Gross Domestic Product |
| EU | European Union |
| IMF | International Monetary Fund |
| MT | Metric Tonnes |
| MTO | Money Transfer Operators |
| NPL | Non-Performing Loans |
| NRBT | National Reserve Bank of Tonga |
| NZD | New Zealand Dollars |
| OET | Overseas Exchange Transactions |
| PAYE | Pay As You Earn |
| TASP | Tonga Agriculture Sector Plan |
| TC Gita | Tropical Cyclone Gita |
| 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

Global economic activities continue to firm up as well as recovery in trade and investment. IMF, in its World Economic Outlook update April 2018, projected global growth at 3.8 percent in 2017 and to strengthen further to 3.9 in 2018 and 2019. Driven by continuing positive and stronger growth projections for the advanced economies while emerging markets and developing economies (EMDEs) will rise before levelling off. Similarly, a positive and increasing growth is projected for the Pacific island economies at 3.7 percent in 2017 and to expand further to 4.4 percent in 2018. It is also noted that likely impact of the Tropical Cyclone (TC) Gita – that made land-fall in number of the Pacific island countries including New Zealand in February 2018 - in the outlook for the Pacific islands economies. A modest growth for Tonga’s main trading partners—Australia, New Zealand and the United States— over the medium-term. On the other hand, given the tight linkages between Tonga and these economies, the development in their economic conditions would definitely one of the key factors that could shape up the trends of aid and remittances to Tonga that could also affect (higher/lower) demand for Tonga’s exports.

MOFNP’s projection for Tonga’s economy for 2017/18 is to grow at around 1 percent due to TC Gita impact during the year. This is a significant drop from an average rate of above 3 percent in the past three consecutive years. The outlook for the medium term is positive and stronger, supported by recovery related activities in construction sector, agriculture and electricity, in addition to the continued vibrant banking sector, increasing trend of remittances from seasonal workers, foreign aid and attendant impacts on other subsectors, sound fiscal policies and development finance support to small scale industries. However, there are potential risks that could affect the growth projection for the medium term. Tonga’s vulnerability to weather conditions, natural disasters and climate change which could largely impact the outlook for the primary sector as well as other sectors as witnessed after TC Gita. Others include the uncertainty in the commencement date of implementation or scale down in size of major construction projects. This could lead to a weaker growth in the near term but somewhat stronger in the outer years. Furthermore, a weaker than expected economic conditions in Tonga’s main trading partners may pose a risk to Tonga’s economy as it might weigh down remittances, tourist arrivals and travel receipts and lower demand for exports. Additionally, risk of high cost of production, higher inflation and lower household disposable income might be occurred if there will be a sharp increases in global commodity prices in the near term. Other potential risk of a high non-performing loan (NPL) could stem from unchecked acceleration in credit growth on financial sector despite its being low.

The average annual inflation rate for March 2018 quarter was 6.4 percent, higher than the average of 5.5 percent in the December 2017 quarter however, lower than the 7.9 percent in March 2017 quarter. On monthly basis, annual inflation rate for March 2018 was 9.8 percent, significantly higher than the 3.4 percent in February 2018 and 9.4 percent in March 2017. Prices development in the global market, domestic policy changes and supply constraints in the domestic market including TC Gita effects were

contributing factors to the growing inflationary pressure. Inflation is expected to remain moderately above the reference rate of 5 percent set by NRBT.

Provisional data indicates a surplus of around \$0.1 million at the end of March quarter 2018 reflecting a sound fiscal control on government spending. Data reveals that revenue collection was sufficient to cater for the total expenditure over the concerned period. On quarterly basis, revenue & grants and expenses for the reviewed period were lowered than the previous quarter, by around 19 percent and 11 percent respectively. The decrease in both the total revenue and grants and total expenditure were expected due to lower economic activities held during the concerned period compared to previous quarter—festive season. For year-on-year basis, both revenue and expenses were higher in the concerned period, compared to the same period a year ago. The increase, about 15 percent, in the grants receipts for various projects, increase in the revenue collected from both tax and non-tax items as well as TC Gita impacts related expenses were the major contributing factors. On the outlook, for the next quarter, both trends may continue to go higher due to more events fall in during the quarter and efforts to be made before end of the financial and also the related TC Gita impacts.

At the end of March 2018, the level of foreign reserves was \$447.7 million; equivalent to 8.0 months of import cover. This is an increase, by \$25.2 million, from the level of foreign reserves in the previous quarter which could be attributed to higher receipts of remittances, up by \$18.2 million over the concerned period. This is equivalent to 8 months of import coverage, reflected that Tonga is still in a comfortable external position that far surpasses the minimum range of 3 – 4 months set by the NRBT. The months of import cover include both imports of goods and services since the revision made in February 2017.

REAL SECTOR

Subdued activities were recorded in the primary sector for March 2018 quarter compared to the previous quarter; however it performed better than the corresponding quarter in 2017. Over March 2018 quarter, the total volume of agricultural exports declined by 77 percent compared to the previous quarter, Dec 2017. The decline indicated the end of the squash pumpkin season and the impacts caused by TC Gita. The impacts were shown by the decrease in the vegetables and fruits, down by 58 percent, and other products particularly from the vanilla cured beans, by 97 percent, as well as taro leaves, by 22 percent.

On year-on-year basis, total agricultural exports recorded for the reviewed period was 36 percent higher compared to same period a year ago. The increase was in line with the increase in the exports of leaves (over 800 percent), root crops (26 percent) particularly from sweet potatoes, taro tarua, swamp taro, giant taro and yam, vegetables and fruits (54 percent) from brown and green coconut, kava products and herbal leaves and medicines. On the domestic market, supplies of root crops were abundant while the local fruits and vegetables declined due to its seasonality as well as impacted by the cyclone.

Positive but moderate growth is projected for the agricultural subsector over the near to medium term, supported by recovery activities and other ongoing government initiatives and good weather conditions.

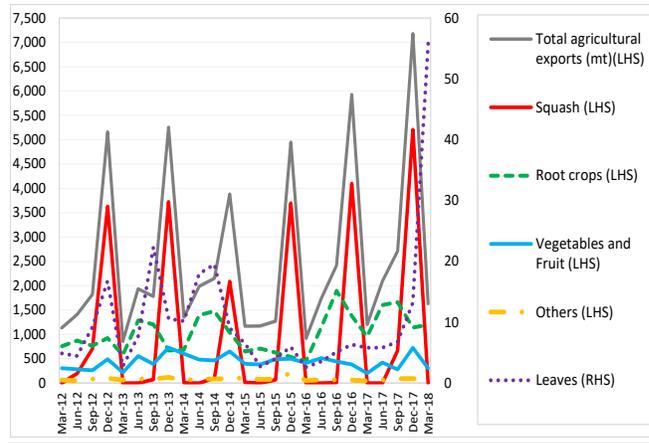
Fisheries sector was affected by TC Gita especially to some of the fishing vessels and other facilities is estimated to continue at its positive but moderate trend supported by recovery activities and other ongoing initiatives.

From the Forestry sector, ongoing activities include re-planting as well as increased in the production of firewood and timber for domestic market.

The outlook for primary sector is anticipated to remain positive in the medium-term. This will be highly supported by recovery activities and various initiatives being undertaken in each of the sub-sector as well as upgrading of rural and agricultural roads.

Over the reviewed period, activities continue in the secondary sector with completion of the Taufa'ahau Tupou IV Domestic Wharf and other ongoing construction activities —both public and private. Additionally, relevant recovery activities are anticipated to start in the near term as well as other construction activities are planned such as Phase

Figure 1: Agricultural Exports (mt), quarterly

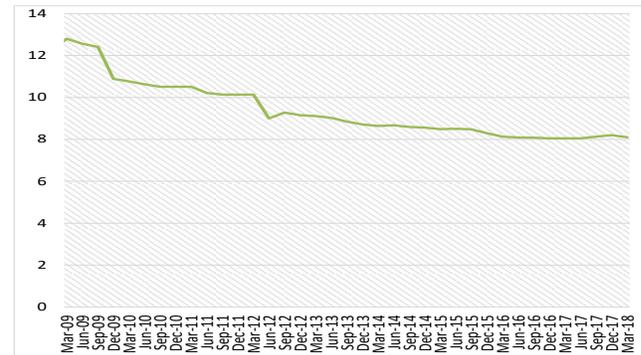


Source: Quarantine Division, MAFF

2 of Tonga High School project and others. Other subsectors are anticipated to move along the same direction as positive outlook for construction activities. As such, inputs from the Mining & Quarrying subsector such as quarries and sand, blocks from Manufacturing subsector, and water and electricity from the Electricity and Water supply subsector, were all required for construction activities, hence, the projection for positive direction and move along with the construction activities.

The other supportive factor for the positive outlook for the construction subsector is also associated with reasonable interest rate on housing loans (*refer* Figure 2). Over the year ended to March 2018, the average interest rate for housing loan remains at around 8 percent, lower than the same periods in the past decade.

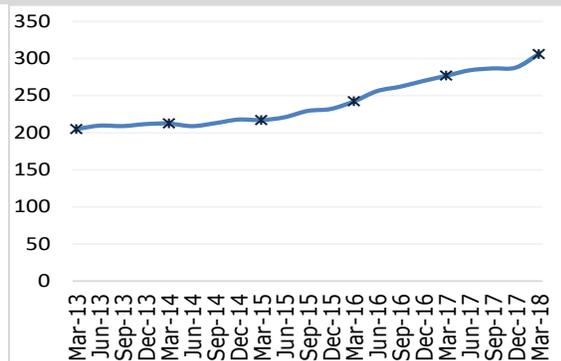
Figure 2: Housing lending rate (%)



Source: NRBT

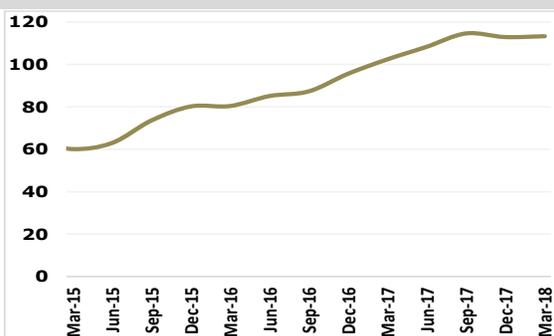
Performance of the tertiary sector were mixed over the review quarter compared to the previous festive quarter, though higher than the same period in 2017. This is highly associated with the impacts caused by TC Gita. The cyclone had impacted services in the following subsectors: the wholesale and retail trade; transport and communication; hotels and restaurants as well as other subsectors. On the other hand, significant increase were noted in the following services such as remittances and travel receipts compared to the previous quarter and same period in 2017. The increase in travel receipts—annual total—for twelve months period ended in March 2018, by 0.4 percent and 10.6 percent compared to December quarter and March quarter in 2017, was partly contributed by the arrivals of relief workers that came as part of relief efforts from New Zealand and Australia. Simultaneously, household or personal credit is anticipated to continue to grow over the reviewed quarter and near term take into account the relief efforts and initiatives offered by commercial banks, Retirement Fund and Tonga Development Bank to support their customers for recovery from the cyclone.

Figure 3: Remittances, annual total (T\$m)



Source: NRBT

Figure 4: Travel receipt, annual total (T\$m)



Source: NRBT

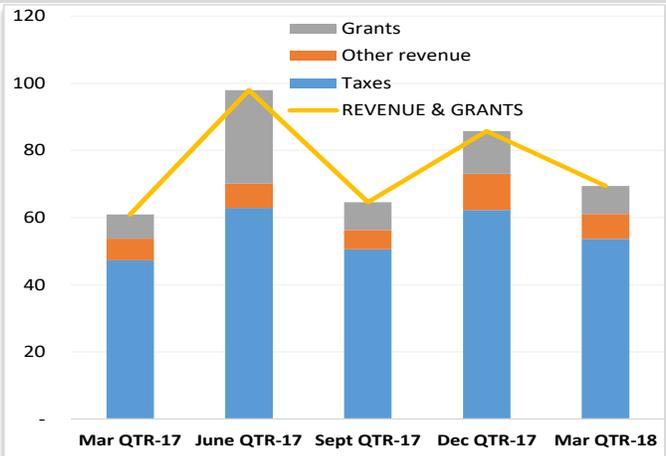
FISCAL SECTOR

The provisional figures for Net Operating Balance (Revenue less Operating expense) registered a surplus of around \$4.5 million at the end of March quarter 2018. This is a result of around \$69.4 million receipts from revenue and grants versus of about \$64.9 million for government spending (above the line) over the review quarter. Available data indicates that total revenue and grants decreased, as usual, when compared to December 2017 quarter. However, it was higher than the same period a year ago. Other noticeable feature was that the total expenses for March 2018 quarter was higher than both the previous quarter and same period in 2017. This is highly associated with the related immediate response activities to TC Gita effects.

Total revenue and grants received during the quarter (Mar 2018) were around 19 percent lower than the previous quarter as a result of lower collection mainly from all tax categories, property income, less disbursement as for development project and no budget support. On annual basis, total revenue and grants has increased by around 14 percent from the same period in 2017. The increase was mainly supported by the increase in collection from tax items such as taxes on income and profits, taxes on goods and services as well as taxes on international trade and transactions. Taxes on goods and services, the highest contributing factor to the increase, included consumption tax (CT) both from imports and domestic, excise tax, motor licenses and registration, annual motor vehicle examination as well as others. Domestic revenue collection at the end of March quarter 2018 contributes around 16 percent to the revised estimates for 2017/18.

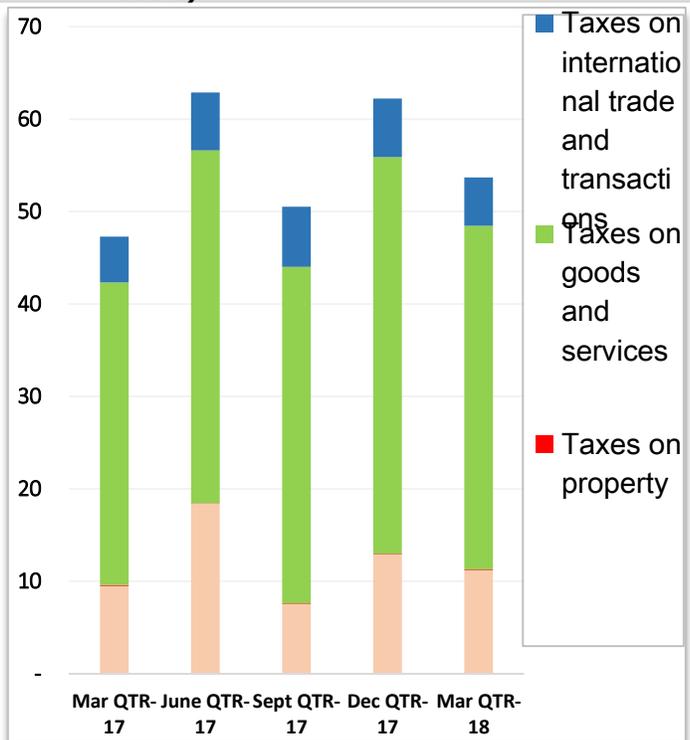
On the expenditure side, provisional data indicates that government

Figure 5: Domestic revenue and Grants (T\$m)



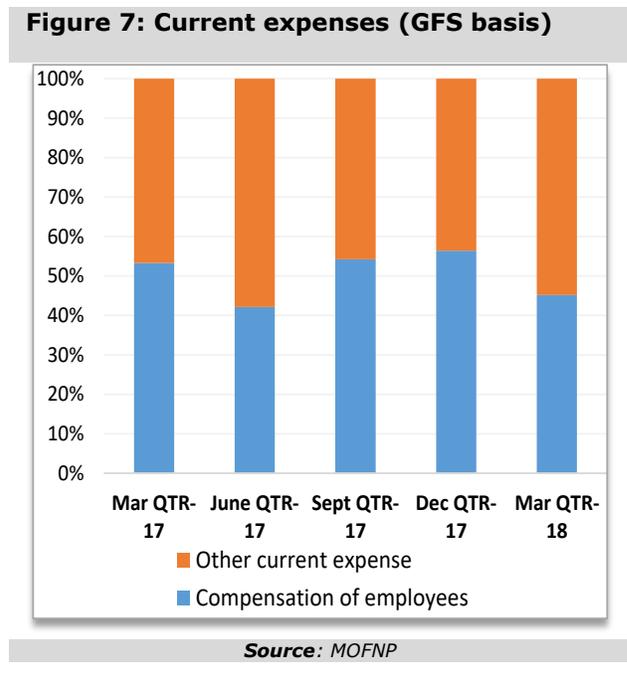
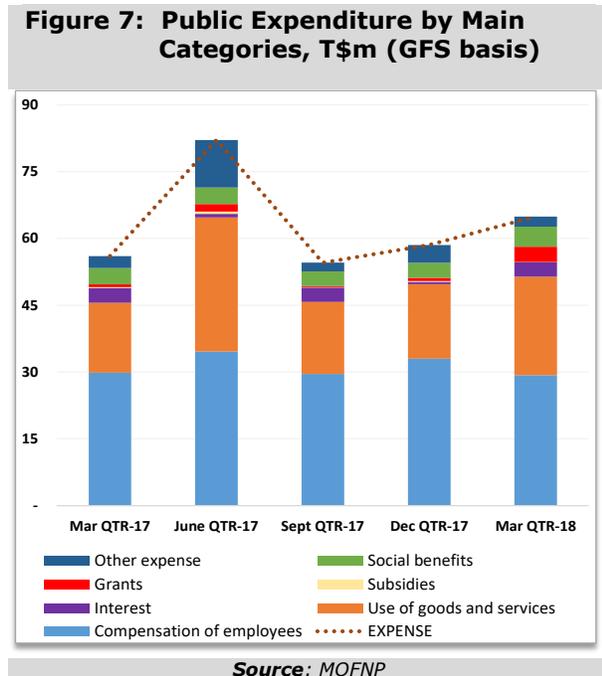
Source: MOFNP

Figure 7: Tax revenue by category, T\$m (GFS basis)



Source: MOFNP

expenditure for the March quarter 2018 was around 11 percent and 16 percent higher than the previous quarter and the corresponding period a year ago respectively. The increase in both periods was mainly due to higher payments on uses of goods and services, grants and social benefits. Over the reviewed quarter, current expenses are estimated that 50.3 percent on average were government spending for compensation of employees and 49.7 percent were for other current expenses. The total expense for March quarter 2018 contributes around 19 percent to the revised budget estimates for 2017/18.



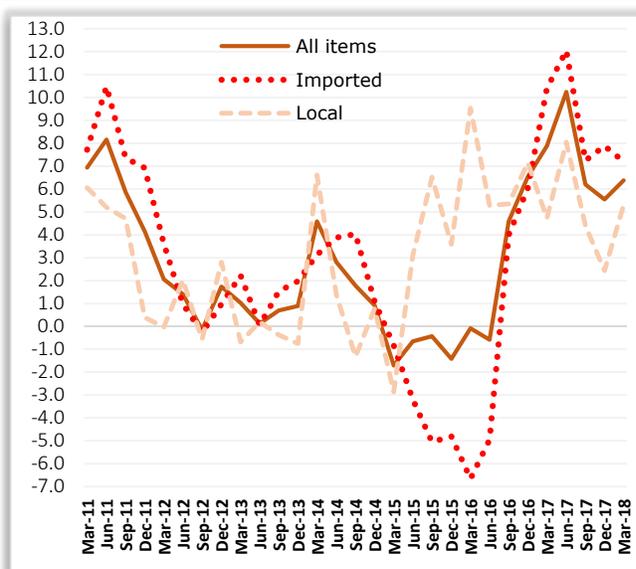
EXTERNAL SECTOR

As anticipated, provisional data reveals lower earnings from export at the end of March quarter 2018 compared to the previous quarter earnings and the same period in 2017—indicating the impacts (year-on-year basis) on agricultural products by TC Gita. This is in line with the Overseas Exchange Transactions record of a lower by 34 percent and 50 percent exports compared to the previous quarter and the same period in 2017. On the other hand, remittances and other official transfers are anticipated to increase supported by TC Gita recovery activities. On the outlook, the Overseas Exchange Transactions Trade balance account for the next quarter will remain in deficit due to higher import payments, despite anticipated higher transfer balance. The anticipated increase in remittances and other official transfers for the next quarter is highly associated with preparation for the annual events such as celebration of the month of family in May, church conferences, schools and ex-students anniversary celebrations, the Heilala festivities as well as many family reunions and other functions. Higher import

payments at the end of the review quarter were due to increase in demand due to related TC Gita recovery activities. Demand for goods and services is anticipated to increase in the next quarter in lining with the annual events as mentioned above. Positive prospects in the medium term for agricultural including the export of squash pumpkin as well as fisheries exports.

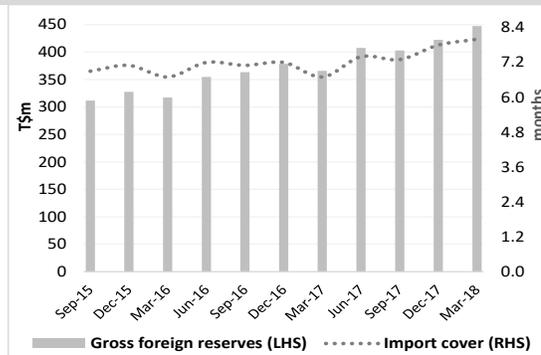
Foreign reserves recorded at the end of March 2018 was \$447.7 million, higher by 6 percent and 22 percent than the December and March 2017 quarters respectively. Seasonally, March quarters used to have lower levels compared to December quarters, however, the higher level was attributed to TC Gita impacts. This has resulted in a higher remittances and foreign aid receipts during the review quarter. The level of foreign reserves recorded for March 2018 quarter was equivalent to 8.0 months of import cover; far exceeded the minimum range of 3-4 months set by NRBT.

Figure 8: Annual Inflation Rate (%)



Source: Tonga Statistics Department

Figure 7: Gross Foreign Reserves vs. Imports Cover



Source: NRBT

MONETARY AND FINANCIAL SECTOR

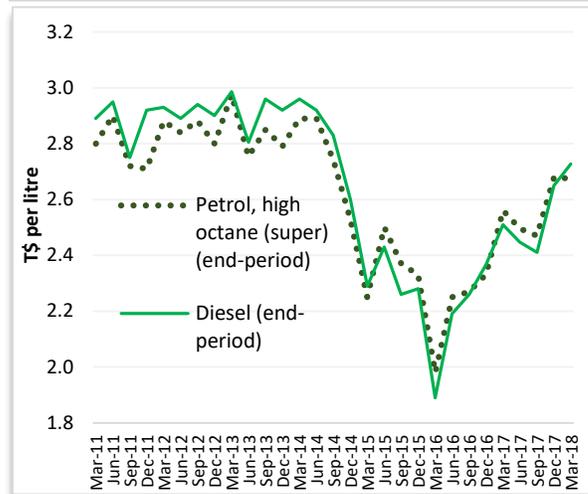
On average, annual inflation rate for the review quarter was, 6.4 percent, higher than 5.6 percent for December quarter, however, lower than 7.9 percent for March 2017 quarter. The year-on-year decrease in the period ended March 2018 was mainly driven by the decline in the imported component at an annual inflation rate of 7.2 percent from 10.4 percent in March quarter 2017. This is reflected by the decrease in the prices of some items from food (8.6 percent), household operations (1.4 percent), transportation (5 percent) and tobacco, alcohol & kava groups (14.6 percent). On quarterly basis, the increase in the March 2018 inflation was driven by higher prices for local component with an annual inflation rate of 5.3 percent. This was supported by the increase in prices of vegetables, fruits and nuts including peanuts, pineapples, pawpaw, tuna and octopus, housing (14.1 percent), clothing and wear component (4.9 percent). Additionally, TC

Gita impacts is one of driving factors added to shortages and increasing price of Kava Tonga. Development in the global market for oil prices due to recovery in the exporting countries has also been reflected in the domestic market.

Domestic price for diesel at the end of March quarter 2018 increased, while price for petrol decreased slightly, when compared to previous quarter. On year-on-year comparison, prices for both petrol and diesel increased when compared to the corresponding period in 2017. This is consistent with the upward movement in global oil price index on year-on-year basis as well as depreciation of the pa'anga.

On the outlook, inflation is anticipated to remain higher above the reference rate of 5 percent set by NRBT. Any changes in global market conditions would be transmitted to the domestic market and impact on our projected outlook for the medium term.

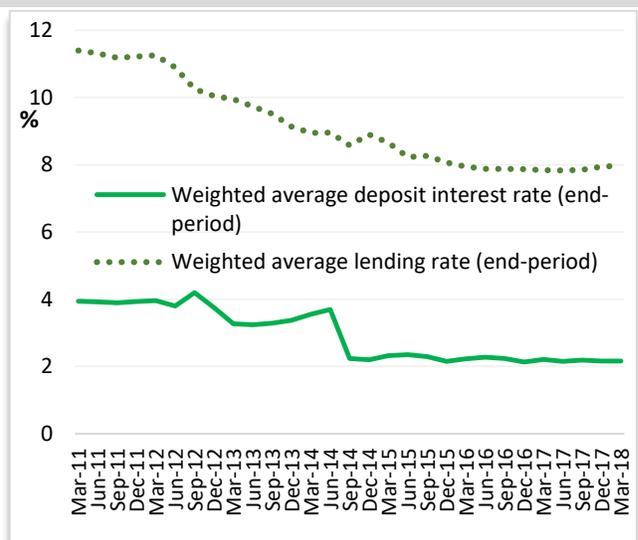
Figure 9: Domestic Fuel Prices (end of period)



Source: Competent Authority, MCCTIL

Weighted average deposits interest rate at the end of March 2018 quarter remained at 2.16 percent the same level as in the December 2016 quarter, however, lower than 2.20 percent in the same quarter in 2016. On the other hand, on quarterly basis, weighted average lending interest rate was 7.97 percent, higher than both the 7.94 percent and 7.85 percent in the the previous quarter and the corresponding period a year ago. The increased in the interest rate for business loan had contributed to the higher rates for the reviewed quarter. If deposit rates continue at a lower rate and lending rates continue to increase, then it would tend to discourage economic activities and challenge economic growth.

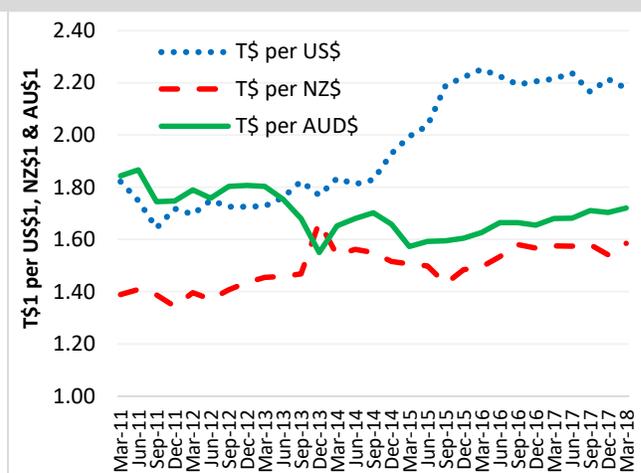
Figure 50: Interest Rate



Sources: OET, NRBT

For March quarter 2018, on period average, value of Tongan Pa'anga weakened against the US dollars while strengthened against the Australian and New Zealand dollars compared to previous quarter. Depreciation in the Pa'anga benefits the recipients of remittances in Tonga and increase demand for goods and services and imports. However, cost of imports would increase and cause upward trend of inflation if the weakening of the exchange rate continues.

Figure 61: Exchange Rate (period average)



Sources: OET, NRBT

RISKS

Despite the positive outlook for Tongan economy in the medium term there remains potential risks and challenges that may affect our projections. Tonga's vulnerability to natural hazard and climate change post a higher risks to our forecast for the Primary sector, as evident in February 2018 when TC Gita struck the country. Additionally, the scale down and further delays of major construction projects could lead to a weaker growth in the construction sub-sector and reduce our growth projections in the near term. Given the size of Tongan economy and being heavy reliance on imported goods and services, any problem in the global market and in the economies of our main trading partners, could post a risk to Tonga's economies activities and overall GDP growth. The impact on Tonga's economy could be through lower remittances, aid, household disposable income and demand for Tonga's exports.

POLICY ISSUES

From global perspectives, the IMF emphasizes the need to raise potential output growth through structural reforms to lift productivity and enhance labour force participation rates, especially in the advanced economies, while making sure that the gains from growth are shared widely. Also, the importance to increase resilience, including through proactive financial regulation and, where needed, balance sheet repair and strengthening fiscal buffers. It is also important to pay attention to the spill-over effects of the change in the US tax policy to the US dollar, higher inflation pressure, tighter

global financial conditions that would have implications for global prices and capital flows.

At the domestic economy, continued application of on-going accommodative and growth enhancing fiscal and monetary policies, timely and efficient implementation of development projects, close monitoring of the TSDF II outcomes, medium term expenditure framework and debt strategy, continued investment in development and infrastructure to boost resilience to natural disasters are continue to be crucial factors to maintain macroeconomic stability and sustainable growth for Tonga.

In mindful of the serious socioeconomic impact of recent disasters, government and stakeholders had undertaken steps and formulation of framework, with the help of development partners, exploring approaches to finance interventions necessary to address disaster and climate change related risk. This includes enhancing local capacity to construct more climate-resilient infrastructure and development of policy that promotes direct responses and coordination to climate change and disaster risk reduction. This might help to tackle such potentially large burden on fiscal expenditure that could result from costs of future natural disasters, especially if donor aid falls short. This also highlighted the importance of maintaining fiscal buffers.

In the same veins, pressures on fiscal sustainability remain as an area of focus for the government, in which this may be compromised should public sector employment reform fail to contain wage growth, or grant disbursements and related high-impact infrastructure project be delayed. Hence, the need to maintain fiscal sustainability remains through prudent PFM and fiscal adjustment as needed to secure fiscal space for growth-enhancing spending. Continuing of a strong enforcement and implementation of the performance management system for public sector and its recruitment policy are also key in government efforts to improve total capital productivity. This also helps to keep level of spending on wages and salaries below fiscal anchors and not posing a threat to budget balances and could lead to higher public debt.

Simultaneously, government must continue its efforts to support SMEs, broaden export basket and trading partners and enabling business climate, enhancing private sector development, continue developing human capital and improving access to finance. Continuing implementation of fiscal and monetary policy measures to dampen the inflationary pressure, increase tourist arrival and private consumption expenditure, boost domestic revenue mobilization, and maintain gross reserves at the current level to strengthen resilience to shocks are all but important as highlighted in the TSDF II. Continued implementation of macro-prudential policies for better management liquidity and high credit growth. Also worth noting for consideration to promote inclusiveness of both formal and informal businesses to help ensure economic growth benefits the broader population at all aspects, with inclusion of relevant initiatives for hardship and poverty alleviation.