



QUARTERLY ECONOMIC UPDATE (QEU) September 2018

**MINISTRY OF FINANCE AND 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.
 - 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 – 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:
- | | |
|---------|---|
| 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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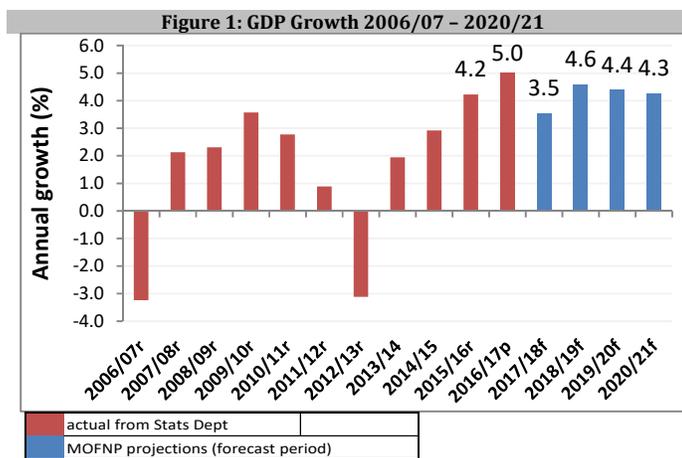
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OVERVIEW

The IMF has revised downwards to 3.1 percent its July 2016 forecast for global growth. This is expected to pick up to 3.4 percent in 2017 and beyond, with growth rebound forecasted for emerging economies (IMF WEO-October 2016). The revision of projected growth for 2016 derives from continuing weakness in global demand, international trade and capital flows and lackluster productivity growth. The outlook for the advanced economies is a moderate growth of 1.6 percent in 2016; again due to subdued business investment, stockpiles of goods as a result of weak demand, lower energy prices and dollar strength. Growth in Japan is expected to pick up in 2017 from a weak growth estimated for 2016 while the UK is projected to grow at 1.8 percent in 2016 and slow down to 1.1 percent in 2017. Subdued growth in the UK is predicated on uncertainty of the Britain's exit from the EU that could take a toll on the confidence of business investors in Europe as a whole. Growth in the Euro area is therefore expected to slow down in 2017 and may require maintaining its current accommodative fiscal and monetary stance and an additional quantitative easing through expanded asset purchases if inflation fails to pick up. Growth in the emerging markets and developing economies is projected to reach 4.2 percent in 2016 and 4.6 percent in 2017. This is in line with the moderate improvement in domestic demand conditions in China and improved prospects for the Chinese economy as a whole during the first half of the year. For the Asia and Pacific region, growth is expected to broadly stable at around 5.4 percent in 2016, and 5.3 percent in 2017 (IMF Regional Economic Outlook, October 2016). Modest growth is projected for Tonga's main trading partners—Australia, New Zealand and the United States—for 2016 and 2017. Stronger conditions in these countries will continue to support growth in remittances to Tonga; increases in the number of people participating in seasonal workers' schemes, and increased demand for Tonga's exports. The outlooks for global and regional economies will certainly impact (positively/ negatively) on the outlook for Tonga in coming years given tight linkages to Australia, New Zealand and the United States.

In the GDP forecast update for Tonga in July 2016, growth for 2015/16 and 2016/17 were projected at around the same level as in 2014/15. This is expected to strengthen in 2017/18 and then slow down slightly at the end of the forecast period. Growth estimates for 2015/16 through 2018/19 are to remain strong at an average of 3.7 percent, owing to expected recovery from drought in agriculture and continuing favorable performances from fisheries and forestry sub-sectors

of the economy. In addition, a robust growth is projected for the construction subsector and the overall secondary and services sectors due to ongoing projects and preparations for the 2019 Pacific Games. Moreover a prospects of a huge decline after 2018/19; predicated upon completion of 2019 Pacific Games construction related projects. This decline (probably a negative growth rate) is however expected to be partly mitigated by spill-over effects post-2019 Pacific games—tourists arrival is expected to grow with increased level of hotel rooms, restaurants and improved infrastructure, so also is domestic spending given enhanced inflow of foreign exchange during and after the games. It is also expected that by 2018/19, the country will start to reap the benefits of the implementation of the TSDf II and associated sectoral strategic plans.



Annual rate of inflation for the year ended October 2016 was 6.1 percent; associated with various changes in prices in the global market, policy changes and supply shortages in the domestic market compared to same period a year ago. The changes in the global oil market in recent times are leading to increases in domestic fuel prices in electricity tariff. Increases in food prices in the global market and impacts of the new customs and excise taxes that recently came into effective in July 2016 are being translated into rising domestic food prices and prices of other goods in the domestic market, compared to same period a year ago. In addition, continuing shortages in the supply of kava adds to the domestic inflationary pressure. The level of inflation rate recorded for October 2016 (6.1 percent) was last experienced since August 2011 (6.2 percent), five years ago. For the rest of the forecast period, inflation is expected to remain moderately above the projected annual average of around 2 percent.

There are obvious risks to that may affect our growth forecast. Projected positive growth for the primary sector remains extremely vulnerable to natural hazards especially now that the region is in the cyclone season. For the secondary sector, a scale down in the size, delay or cancellation of major construction project(s) could lead to a weaker growth over the forecast period. Furthermore, weaker than expected economic conditions in Australia, New Zealand and the USA may pose a risk to the Tongan economy as negative impacts will be witnessed in the level of remittances, tourist arrivals and demand for exports. A sharp increase in the global commodity prices over the forecast period also pose a severe risk to Tonga as it may lead to increases in costs of production, drive up inflation and reduce household real incomes. On the domestic front, the strong credit growth could threaten financial stability; there is strong evidence of growing idle liquidity in the banking sector. The current level of housing loans recalls mirrors the challenges faced by the banking sector from increased non-performing loan witnessed in March 2008. This again could pose a risk for the banking sector that may require governmental bail out measures.

Domestic revenue increased both from tax and non-tax items by 6.1 percent and 17 percent respectively compared to same period a year ago. This is a reflection of the coming into effect of new customs and excise taxes at the beginning of the review period. Additional revenue collected from the foreign exchange levy for the Pacific Games of over \$1 million during the review period is also worthy of note. Domestic revenue collected at the end of September quarter 2016 contributes around 22 percent to the budget estimates for 2016/17.

Provisional data indicates that government expenditure for September quarter 2016 were around 24 percent and 3 percent lower than the previous quarter and the corresponding period a year ago respectively. The decrease in the quarterly trend was mainly due to lower payment made for compensation of employees as a result of implementation of the policy of recruitment freeze for staff below level 9 at the beginning of the review quarter. In addition, reduced expenditure have been recorded on goods and services, subsidies for development committees, grants, social benefits under the social welfare scheme and vulnerability, pensions & gratuities and others during the review quarter. The estimated 3 percent decrease in annual expenditure is due to decline in the same line items—use of goods and services, subsidies, grants and other expenses. The total expense for September quarter 2016 contributes 16 percent to the Budget Estimates for 2016/17. Provisional data indicated a surplus of around \$1.4 million recorded at the end of September quarter 2016.

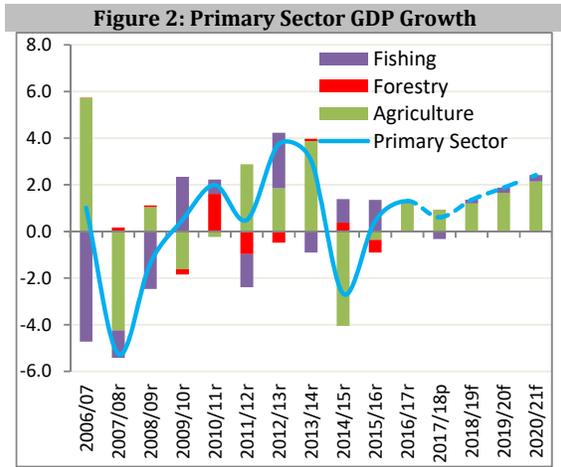
The level of foreign reserves recorded at the end of October 2016 was \$367.0 million; equivalent of about 9.3 months of import cover. The increase when compared to previous month and same period in 2015 was mainly due to higher foreign aid for various projects and remittances. The 9.3 months of

import cover continues to highlight that Tonga is still in a comfortable external position that far surpasses the minimum range of 3 – 4 months set by the NRBT.

REAL SECTOR

PRIMARY

Positive growth is projected for the primary sector in 2017/18 assuming a recovery from drought effects in the agriculture sector in conjunction with continuous positive performance in the fisheries and forestry sub-sectors. Moderate growth is expected for the rest of the forecast period this is clearly reflected in the increase in volume of the total agricultural exports.

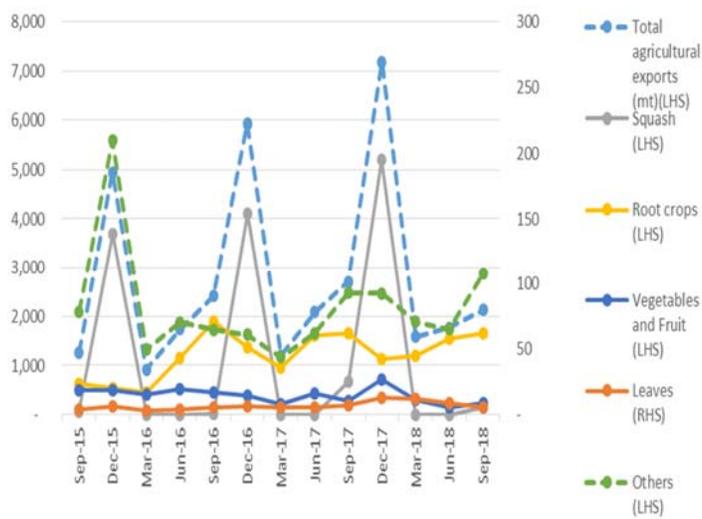


Sources: Statistics Department and Ministry of Finance and National Planning

Total volume for the agricultural exports for the September quarter 2018 was increased by 21 percent than the previous quarter, due mainly to significant increases in the exports of root crops particularly cassava, giant taro and yam and taro tarua leaves. On year on year basis, total agricultural exports for the review period was 21 percent declined compared to same period a year ago. The decrease caused by the impacts of cyclone Gita together with less rainfall on the previous quarter caused decreased taro leaves by 24 percent and vegetable and fruits by 53 percent. On the domestic market is projected to continue to increase due to the harvesting season, good weather season and supported by recovery activities.

Fisheries subsector value of fisheries products exports increase by 214 percent compared to the

Figure 3: Agricultural Exports (MT), quarterly

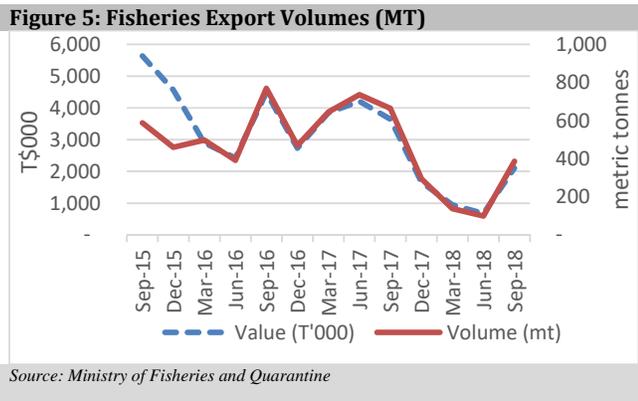


Source: Ministry of Agriculture, Food, Forestry and Fisheries

previous quarter, due mainly from increase in the export of tuna, live hard coral, snapper and shark meat, but compared to the corresponding period last year it was lower by 42 percent. The decrease in annual trend is attributed to the impacts caused by TC Gita to some of the fishing vessels and the total value of fisheries exports for quarterly March and June.

The Forestry sector is expected to continue its positive growth trend over the forecast period. Expected increase in the production of electricity poles for recovery activities and increased in the production of firewood and timber for domestic market.

Outlook for primary sector is anticipated to continue to grow at positive trend through to the end of the forecast period. The positive outlook is continued to be supported from the effects of Agricultural Market Fund and Fisheries Development and Export Fund also the supported by recovery activities and various activities being undertaken in each of the sub sector as well as the upgrading of rural and agricultural roads.

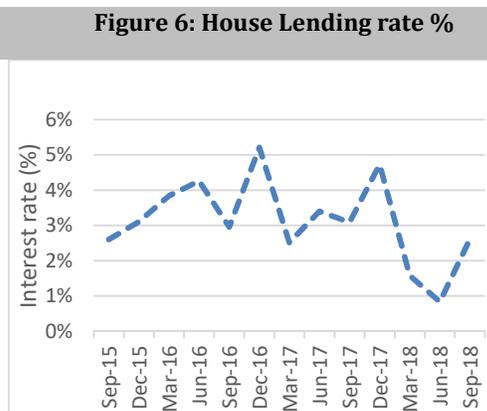


SECONDARY

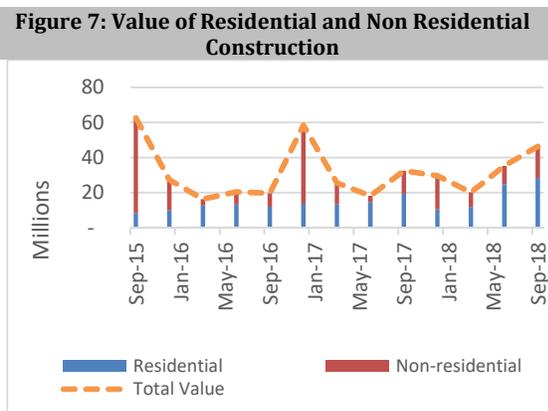
Growth prospects for the secondary sector remains favorably due the level of ongoing construction activities—both public and private. These include construction project for Gita recovery, and other church buildings, the extension of fiber optic cable line to Vava’u and Ha’apai islands and church buildings. Others are the Tonga Transport Sector Consolidation Project, Tongatapu Village Network Phase 1 Upgrading Project and Outer Islands Renewable Energy Project (OIREP), and renovation of Fuaamotu International airport and Climate resilience sector project account (CRSPA). Further expansion is expected later in January 2018/19 through the forecast period . Positive growth may however be expected at the end of the forecast period like the ongoing project like Climate resilience sector project (CRSPA), Pacific Resilience Programmed (PREP) and Tonga Village Network Upgrade Project (TVNUP) and project for sports like the new swimming pool and Tonga high school complex came to a hold for further discussions to reconsider the project scope for redesigning.

Negative outlook for the construction sub-sector is observed by interest rate increase at the decreasing rate on housing loans (Figure 6). This tend to spur the value and number of building permits issued (Figure 7) and the observed increase in import and local buying of construction materials and it indicate high level of activities going on in the construction sector and somewhat call for policy attention as a precaution.

Projections for manufacturing, electricity and water supply are for continuing growth due to the impact of Tongatapu Village Network. Expected increase in tourists arrival pre, increase in the number of cruise ships docking at the expanded Nuku’alofa Vuna ports are to strengthen the growth anticipated for the secondary sector.



Source: National Reserve Bank of Tonga

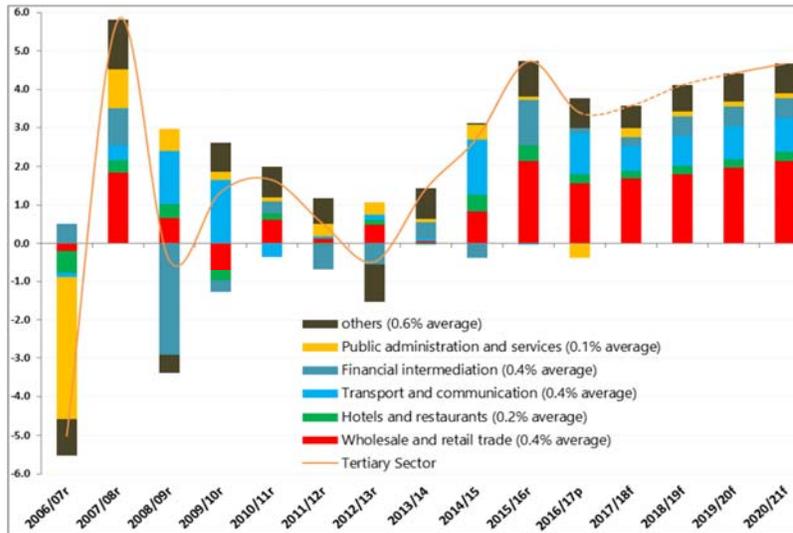


Source: Ministry of Infrastructure & Tourism

TERTIARY

Growth in the tertiary sector is expected to be stronger in 2017/18 than in 2016/17. A moderate slowdown is expected in 2017/18 and this trend will move upward again from 2018/19 to 2019/20 to around 3 percent, which is the same as projected 2.4 percent average growth rate for the forecast period.

Figure 8: Tertiary Sector GDP growth (%)



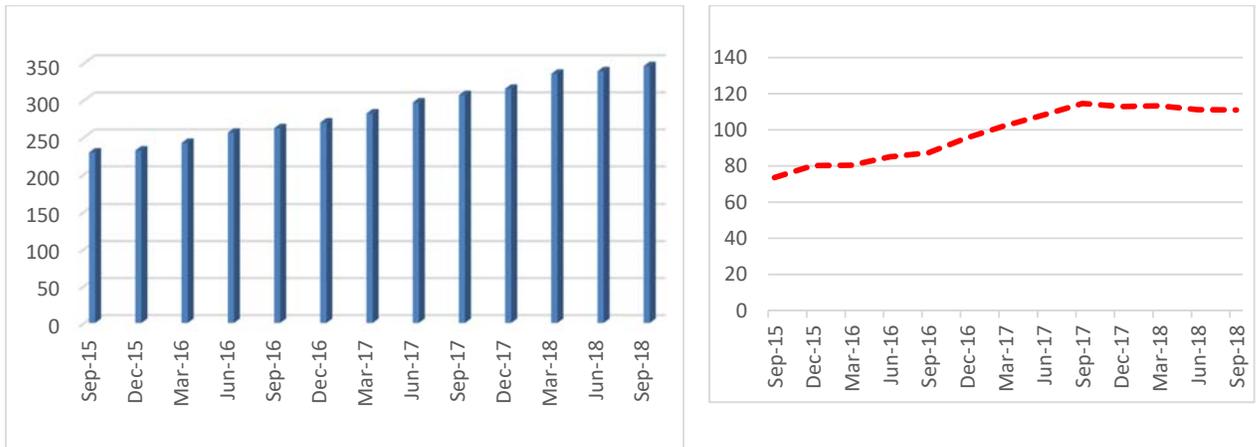
Sources: Statistics Department & Ministry of Finance and National Planning

The projected moderate slowdown in 2016/17 is due to normalization of domestic demand, post 2015/2016 events. The preparations for the 2019 Pacific games—another one-off event—will spur demand again over the rest of the forecast period. The events create higher demand for services as reflected in almost all of the sub-sectors of the services sector, as illustrated in Figure 12 for the two years – 2014/15 and 2015/16 – and rest of the forecast period.

The increasing numbers of tourist arrivals and receipts as well as the increased demand for the transport and communication services are indications of the growth enhancing effects of the events. The expected opening of the Tanoa Hotel in November 2016/17 implies rooms will be made available to receive accommodate the growing number of tourists.

Other factor that largely influenced the projections for the sector is the development in the government sector particularly the recruitment policy; freeze in the recruitment of posts at level 9A and below in March 2016 is of interest in this regard. Growth estimates for public administration/services are likely to be impacted by the public sector recruitment policies. Prospects for the services sector are favorable and consistent with the trends being illustrated in Figures 9 – 14.

Figure 9: Remittances, annual total (T\$)



Sources: National Reserve Bank of Tonga

Figure 10: Travel Receipt, annual total (T\$m)

Sources: Statistics Department & Ministry of Finance and National Planning



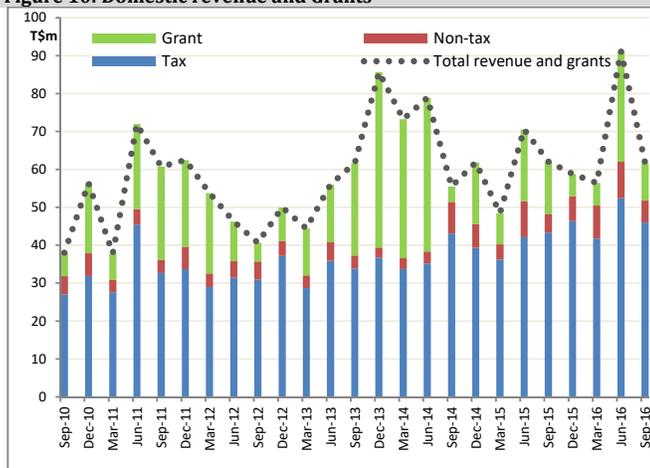
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The increasing trend of remittances and its importance to the economy of Tonga is highly appreciated. However, an issue that seems to pose a potential risk is the threat of proposed closure by some of the Money Transfer Operators (MTOs) as it may negatively impact on the remittance flows. Fund transfer through the MTOs are very much cheaper and convenient to smaller island countries, such as Tonga compared to what banks and other more formal financial institutions offer. This said there is a need for a closer scrutiny and inspection of the activities of the MTOs as to align with the efforts aimed at combating money laundering and terror financing (AML/ CTF).

FISCAL SECTOR

Total revenue and grants are estimated to fall slightly by 0.8 percent from the same period in 2015/16, due mainly to reduced receipts from donor grants. Furthermore, no budget support has been received during the review quarter. However, domestic revenue increased both from tax and non-tax items by 6.1 percent and 17 percent respectively compared to same period a year ago. The increases reflect the new customs and excise tax imposed at the beginning of the September quarter. On quarterly basis, total revenue and grants received in

Figure 10: Domestic revenue and Grants



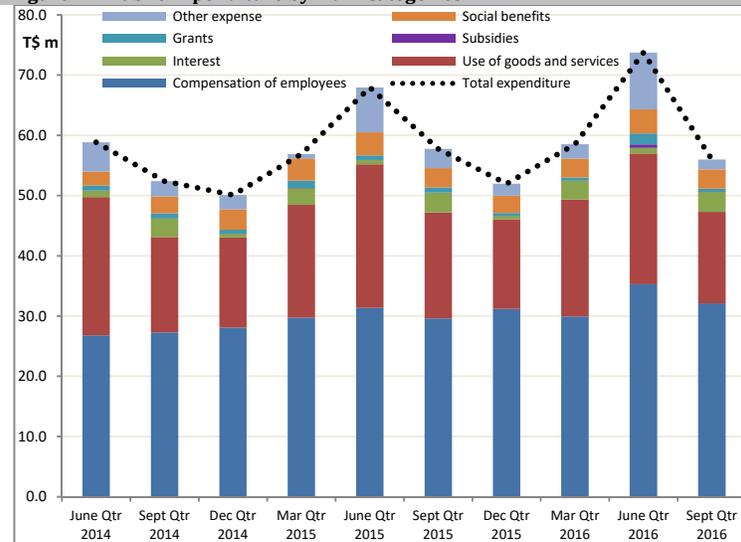
Source: Ministry of Finance and National Planning

September quarter 2016 were around 33 percent lower than the previous quarter. The decreases in quarterly receipts were mainly due to decrease in collection from PAYE (24%), Corporate taxes from both small and large businesses (about 26% and 87% respectively), tax on property as industrial properties registration (33%), and consumption tax from imports (about 4%). Other significant feature of revenue collection in the September quarter is the effect of the new customs and excise tax imposed at the beginning of July 2016. Collection from Excise tax alone was around 145% higher compared to June quarter. In addition, collection from business import duties was around 5% higher than in the previous quarter. Additional revenue of over \$1 million has also been collected from the foreign exchange levy for the 2019 Pacific Games. Domestic revenue collected at the end of September quarter 2016 contributes around 22 percent to the budget estimates for 2016/17. Cash grants receipts in the September quarter 2016 were down by 66 percent when compared to previous quarter. During the September quarter, \$0.7 million was received as budget support from the Government of New Zealand.

Provisional data indicates that government expenditure for September quarter 2016 was around 24 percent and 3 percent lower than the previous quarter and the corresponding period a year ago respectively. The decrease in the quarterly trend was mainly due to lower payment made at the first quarter of the current financial year as compensation of employees (by 9 percent) reflecting the implementation of the policy for no further recruitment of staff below level 9 which became effective in July 2016 may account for this. Other factors in the lower quarterly expenses are lower payment for uses of goods and services (by 30 percent), subsidies for development committees (by 97 percent), grants (by around 70 percent), social benefits as for social welfare scheme and vulnerability and pensions & gratuities (by 20 percent) and other expenses (by around 83 percent) made during the September quarter. Factors accounting for the 3 percent decrease in annual expenditure are lower payment for use of goods and services (by around 14 percent), subsidies (by around 33 percent), grants (by 37 percent) and other expenses (by 49 percent).

The decreases in payments for goods and services that account for the quarterly and annual downward trend were due to the decline in expenditure on electricity, fuel, freight, medical supplies and maintenance expenses (office equipment, vehicles, and roads) and hire of heavy machinery. The total expense for September quarter 2016 contributes 16 percent to the Budget Estimates for 2016/17.

Figure 11: Public Expenditure by Main Categories



Source: Ministry of Finance and National Planning

Provisional data indicated a surplus of around \$1.4 million recorded at the end of September quarter 2016.

EXTERNAL SECTOR

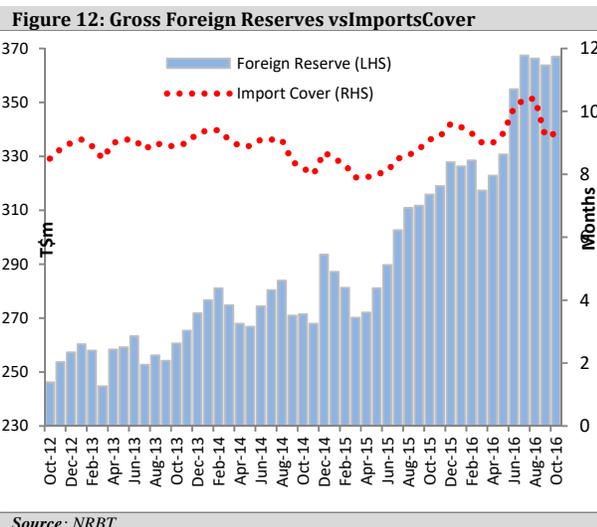
The expected earnings from export at the end of November 2016, as indicated by provisional data, could lower than both in the previous month and same period a year ago. The decrease on monthly basis was contributed by 98 percent decrease in exported volume of squash pumpkin, 18 percent from root crops – mainly yam and cassava. The decrease in annual trend could be supported by 98 percent decrease from the exported volume of squash pumpkin, 14 percent from vegetables and fruits and 37 percent from kava. Latest available data for fisheries exports – September 2016, indicated an increase mainly from tuna, snapper and shark meat.

The Overseas Exchange Transactions Trade balance account for December 2016 is assumed to remain in deficit due to more import payments, despite the anticipated higher transfer balance. Increase in remittances and other official transfers associated with the preparation for the Christmas and New Year season as well as many family reunions and other functions are the push factors for higher transfers.

Latest data available for import payments – October 2016, indicated an increase in lining with continuing increase in the global commodity prices. Demand for goods and services is anticipated to increase in the December quarter due to preparation for the Christmas and New Year festive season with various functions that are normally held around this time. Growth in the demand for construction materials is also anticipated to spur import payment for the same month; lots of construction activities are currently underway and many are expected to start in the near term in preparation for the 2019 Pacific Games.

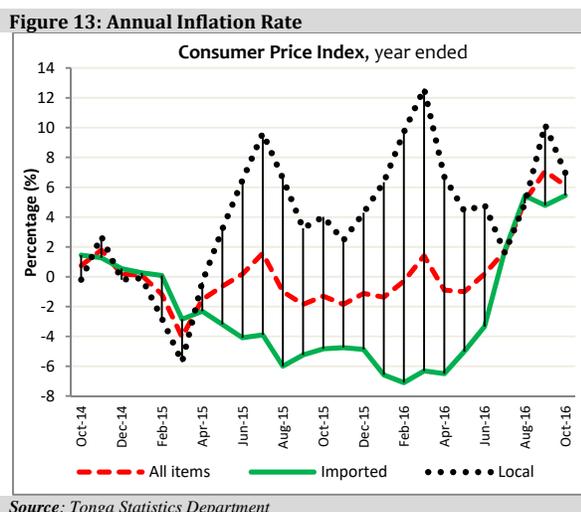
The outlook for the current account of the BOP is for a slowdown in deficit in the near-term if export of squash pumpkin improves and given the positive prospects for exports of other agricultural products and fisheries.

The level of gross foreign reserves recorded at the end of October 2016 was \$367.0 million; equivalent to 9.3 months of import cover. This was around 1 percent higher, by \$3.3 million, compared to previous month and about 16 percent or \$51.2 million higher than what was recorded at the end of October 2015. The increase on monthly basis was mainly due to higher receipts of budget support and foreign aid during the review period. The 9.3 months of import cover highlights a fact that Tonga continues in a comfortable external position that far surpasses the minimum range of 3 – 4 months set by the NRBT.

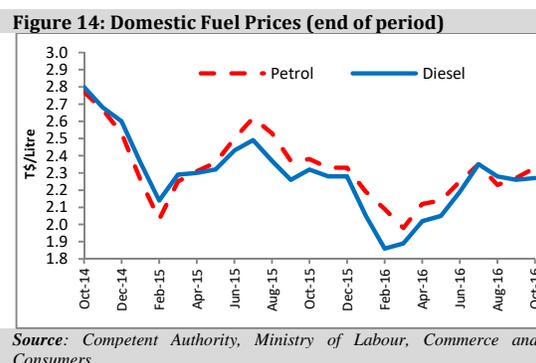


MONETARY AND FINANCIAL SECTOR

The annual inflation rate at the end of the October 2016 was 6.1 percent compared to 7.1 percent recorded for September 2016 and -1.3 percent for October 2015. The significant increase from same period a year ago was mainly driven by imported component with an annual inflation rate of 5.5 compared to -4.8 and 7.0 compared to 4.0 from local component. A huge jump in price of Kava led to an annual inflation rate of 28.8 for Tobacco, alcohol and Kava component. The Food component registered the second largest inflation of 7.0 was driven by a combination of local and imported goods impact. The increase in prices of imported food items—meat and poultry—are ascribed to the new customs and excise tax that became effective in July 2016. In addition, the appreciation of the NZ and Australian dollars also contributed to the increase in price of imported components of the CPI. Furthermore, increase in the price of kava continues to drive the increase in price of all local items. Price of fuel in the domestic market continues to increase, gradually reflecting the recovery in the oil exporting countries in the global market from lowest price level in the last 10 years.



Domestic price for petrol and diesel at the end of October 2016 decreased on year-on-year basis. This is in line with subdued global oil price index on year-on-year basis. Moreover, the 3 percent and 0.4 percent increases respectively in monthly trend were due to the recent increases in global oil prices, including the Singapore refined petrol prices during the months of the last two quarters. The depreciation of the pa'anga and higher cost of freight also added pressure to price increase. The

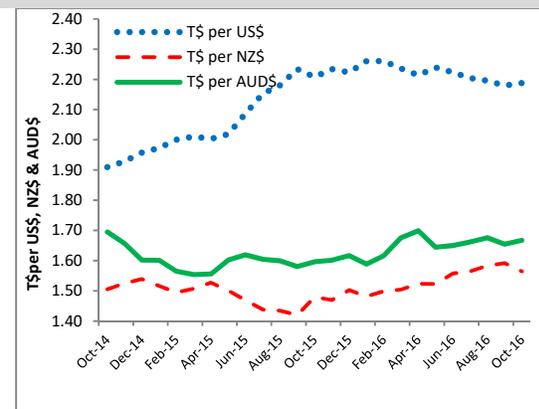


real trade weighted index shows an increase by 0.3 and 4.6 percentages compared to previous month and same period last year respectively. This is consistent with observed higher imported price for the Transportation and Household Operations—up by an average of 0.3 percent—components of the CPI at the end of October 2016.

The outlook for inflation in the medium-term is anticipated to remain higher than the average of 2 percent. This is in line with expected external conditions such as the supply side in the global oil market, in addition to the impacts of new customs and excise tax imposed at the beginning of this financial year. However, there remains significant uncertainty about the outlook for global commodity prices consequent upon geopolitical risk in the oil producing countries and subdued global aggregate demand growth. Changes in the global market would invariably be transmitted to the domestic market and impact on our projected outlook for the medium term.

At the end of October 2016, on period average, the New Zealand dollar appreciated; while the US and Australian dollar depreciated against the Pa’anga compared to previous month. These movements are due to changes in trading partners’ economies; increases in global commodity prices have affected the values of the NZD. The USD and AUD have been depreciating as the economy strengthens amidst possibilities of a rise in the Fed rate. If the weakening of the exchange rate continues, it will increase cost of imports and exert upward pressure on inflation. On the other hand, the depreciation in Pa’anga against the AUD and USD benefit the recipients of remittances in Tonga; while same is not the case for recipients of the NZ dollar.

Figure 15: Exchange Rate (period average)



Sources: OET, NRBT

RISKS

Despite the positive outlook for the medium-term, there remain substantial risks. The potential risks that could affect our projections include high vulnerability of our forecast for the Primary sector to weather conditions—we are now in the season when tropical cyclones and other natural hazards most frequently occur that could probably pose some risks to the agriculture sector. Additionally, delays in the commencement of major construction projects could lead to a weaker growth in the construction sub-sector in near term. Cancellation and/or scale down of projects could also lead to subdued growth throughout the forecast period.

Tongan economy is still highly dependent on the economic conditions of our major trading partners (Australia, New Zealand and the United States of America). Downturn in these economies would definitely pass through in terms of lower remittances and demand for Tongan export. Lower remittances negatively impact disposable incomes and limit domestic spending on goods and services. All these will lead to a slowdown in domestic activity and slower overall GDP growth.

Due to the smallness of Tongan economy and its dependence on the global market, Tonga remains highly vulnerable to external shocks. For instance, the fluctuations in the global commodities' prices have become the underlying factor for spikes in costs of production, inflationary pressure and dampening household real incomes.

CONCLUSION AND POLICY ISSUES

From global perspectives, the IMF warns that situations in many advanced economies could further dampen global growth. Some of these include the spill-over effects of the United Kingdom's exit from the European Union, tighter credit conditions, major exchange rate fluctuations, and further weakness in commodity markets. While the near-term outlook for Asia remains strong, there remains the need for accommodative policies amidst recent easing of 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 programmes 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. At the same time, current government efforts aimed at supporting SMEs and diversifying the export basket and trading partners, enhance business-enabling structural reforms and improve efficiency of the public sector must be maintained. Implementation of current recruitment policy for public sector is noted and highly appreciated; it is important to maintain the low wage bill recorded for the September quarter 2016 so that resource basket to boost key economic sectors will continue to be available. Higher government spending on wage bill, as earlier experienced, poses a threat to budget balances and lead to higher public debt; a risk to debt sustainability. In addition, fiscal and monetary policy measures to dampen the inflationary pressure, enhance tourist arrival and private consumption expenditure, spur domestic revenue mobilization, and maintain gross reserves at the current level to strengthen resilience to shocks are all but important as stressed in the TSDF II. Furthermore, macro-prudential tools to better manage liquidity and credit cycle will need to be strengthened. 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.