MINISTRY OF FINANCE

HALF-YEARLY ECONOMIC UPDATES 2018/19

(July-December 2018)

ECONOMIC ANALYSIS
ECONOMIC and FISCAL POLICY DIVISION
MINISTRY OF FINANCE
GOVERNMENT OF TONGA

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 (RGDP) and Nominal GDP are linked through a measure of the price level.
   - The fiscal/financial 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 2017/18 – 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)
T$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) Acronyms

ADB	Asian Development Bank
AUD	Australian Dollars
CPR	Corresponding Banking Relationships
CT	Consumption Tax
EU	European Union
GDP	real Gross Domestic Product
IMF	International Monetary Fund
mt	Metric Tonnes
MTO	Money Transfer Operators
MV	Merchant Vessel
NRBT	National Reserve Bank of Tonga
NZD	New Zealand Dollars
OET	Overseas Exchange Transactions
PAYE	Pay As You Earn
PEM	Pacific Economic Monitor
PRC	People's Republic of China
T$	Tongan Pa'anga
TASP	Tonga Agriculture Sector Plan
TC GITA	Tropical Cyclone GITA

UK	United Kingdom
USA/US	United States of America
USD	United States' Dollars
WEO	World Economic Outlook

Summary

The Global economy was downgraded due to the slowing down in economic activities in large economies. As numbers are depicting a slower movement in activities, warning has been issued to leaders as pressure starts to build up. The developing economies also depicted a much slower pace in economic activities while facing high debt risks. The domestic economy also reflects the same story as revenue from taxation slightly fell compared to the same period of previous years, remittances slows down. However, other indicators continue to move at a faster pace, at the same building up risks on those sectors such as the financial sector.

Risk continues to tilt to the downside due to effects of climate change and will continue to remain as a threat to the domestic economy.

Overview of Economic Performance, Outlook and Highlights

The end of 2018 marked a descending trend due to a slowing down in economic activities, which signalled possible threats to the global economy. While there are grounds to believe, the situation is not too serious, there is plausible advice to remain cautious in considering that risks are beginning to materialize. This is reflected by the published growth numbers in the third quarter of 2018 for some of the world's leading economies, though they still grew, most of the activities rate were worse than expected. For instance, the first contraction in Europe's largest economy is Germany where growth slipped by 0.2 per cent between June and September 2018, since 2015. China's projected growth to moderate from 6.9 percent in 2017 to 6.6 percent in 2018 and 6.2 percent in 2019 were attributed to a slowdown in external demand growth and tightening in financial regulations.

Leading Economies in the Asia and Pacific Region has shown mixed pace. The economic growth in the People's Republic of China (PRC) has undergone a very pace since 2009 while at the same time facing domestic debt risk in addition to trade conflict with the US. The economy decelerated to 6.5% in the third quarter of 2018 due to weakening domestic demand. This is due to a rise in the cost of borrowing as government sets a control on lending by online finance companies and other private sector businesses that avoid the state-controlled banking system. However, in an attempt to alleviate the impact of the trade dispute with the US, the government has been gradually easing fiscal and monetary policies. These factors have lowered the growth forecast for 2019 from 6.6% to 6.3%.

Despite a strong rebound in the previous quarter of 2018, the Japanese economy contracted at an annualized rate of 1.2% in the third quarter as the economy slowed down due to recent disasters that affected Japan. Exports fell by 1.8% as a result of the disaster and also Japan's vulnerability to the trade conflict between the US and the PRC. Japan's exports to China fell in September—the first time in 7 months. China is Japan's largest trading partner. Japan's economy is expected to slow to 1.1% for the full year 2018 and further ease to 1.0% in 2019.

Australia estimated growth at 3.3% in the first half of 2018 and 3.4% for the second quarter, led by increased consumer spending and demand for new homes. Household consumption rose by 3% over the year. The increased government spending and sustained level of exports supported the latest economic expansion. Concurrently, slow growth in wages helps to maintain spending at a slower pace. The Australian economy estimated growth of 2.9% for 2018 and slightly lower by 2.8% in 2019.

Across the Tasman, New Zealand's economy grew by 0.8% in the first half of 2018 with a first quarter growth of 0.5%. Growth across major industries supported the strong growth of 4.1% in agriculture sector with higher milk production due to favorable weather conditions and increased sheep and beef cattle farming. This momentum is expected to continue up to 2019, whereas the slowdown in activity in China poses a downside risk to its exports.

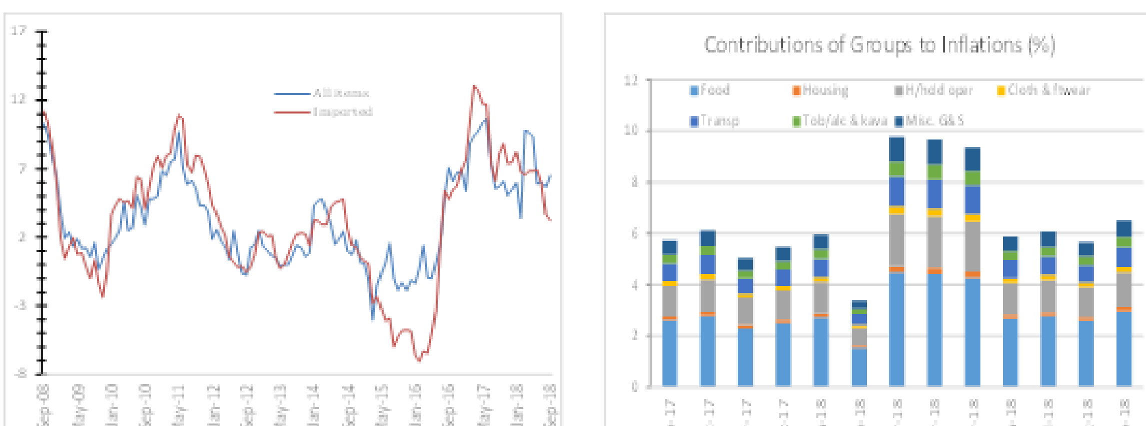
The Tongan economy was estimated to grow by 1.1 percent in 2017/18. Growth rate was revised down followed Tropical Cyclone Gita, taking account the cyclone's impacts on the various sectors of the economy ranging from shelters, agriculture, fishing, retail services, electricity and water and public administration sectors. The huge loss in the agricultural sector resulted in a price increase of local items. The government's disaster recovery program to maintain the livelihoods of the country assisted in reviving the growth rates for 2017/18 and 2018/19.

The implementation of major recovery projects have now rescheduled to occur in 2019/20. This delay will slow down the growth in 2018/19 and contribute to the growth of 2019/20.

Inflation remained contained at 6.6 percent (year-on-year) in November 2018, led by the changes in food prices and transport sector. Inflation largely reflects to a large extent the previous changes in imported items and movement of oil prices in the last decade. Changes in food prices dominate the fluctuation in prices with contributions around 45 percent of inflation. Around 60 percent of food items in the basket are imported items. Oil price has contributed to a large extent to inflation which is expected to increase further in tandem with more import of vehicles to Tonga.

Inflation is expected to remain stable at 6.6 percent for the current financial year given the current economic situation and the relatively low impact by the external sector.

Figure 1: Inflation rate and Contributions of each Groups



Source: Statistics Department

The outlook for the medium term is stable with risks on the downside. The downgrade of global growth still poses threats to inflation. Still we have not fully capture China's integration and response that the broader globalization of commerce creating a disinflationary environment benefiting emerging markets.

Oil market is expected to be over supply with global price expected to fall. This may reduce the rate of inflation. While near-term prospects are favorable, risks to outlook are tilted to the downside. In 2019/20, growth was expected to be stronger at 3.1 percent as forecasted in March 2018, driven by recovery projects in the construction sector, communications, and manufacturing.

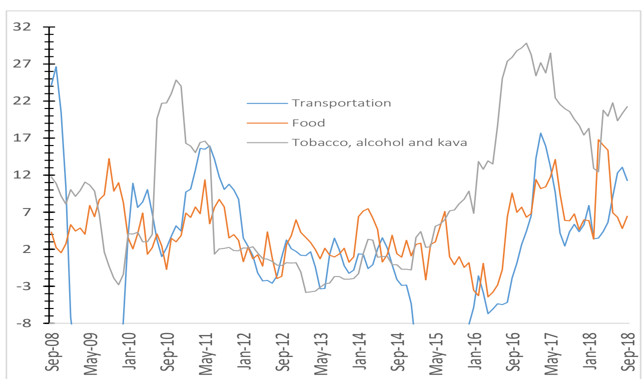
In 2018/19, fiscal policy was expanded to address the recovery from Tropical Cyclone Gita with a guided fiscal surplus to also address the vulnerability of the economy from shocks. The fiscal surplus was estimated at 0.12 percent of GDP, which was forecast to be stronger as a result of the rolling over of major construction projects for the next financial year.

Additional spending was planned to be financed by a drawdown in Government's reserve towards the Disaster Recovery Framework. While the deferment of loan repayment to China provides Government with more extended fiscal space, it is critical that the Government's overall fiscal position needs to be prudently managed in view of a shorter repayment period as well as possibilities of budget deficits.

The monetary policy stance has been very accommodative in an effort to support growth. Net domestic credit growth has been soft in the past 12 months reflecting a slowdown in lending which maintained the level of credit at an average of $333 million in the last 7 months of December 2017 to June 2018. Total level of lending to the private sector is declining reflecting no further loans to the private sector during the same period. Total liquidity at end-June 2018 was recorded at $504 million compared to $456 million recorded at end-June 2017.

Foreign Reserves remained high above $450 million at $470.1 million at end-November 2018 relative to end-November 2017 ($424.8 million), equivalent to 7.5 months of imports. The balance of trade (OET basis) deficit is expected to remain at 3.7 percent of GDP for 2018/19, while the external position is forecasted to remain strong with net international reserves projected at 7.5 months of imports.

Figure 2: Leading items for inflation



Source: Statistics Department

Remittances growth has slowed down in September and October since August 2018 by 0.1 percent respectively since rising consecutively for the last 12 months by a monthly average growth rate of 1.54 percent. Remittances make up nearly 33 percent of GDP and Tonga is ranked fourth in the world in terms of reliance on remittances. In comparison to other Pacific Islands, Samoa's remittances is made up of nearly 18 percent of its GDP and 14 percent for the Marshall Islands.

On average, 90 percent of the remittances are private transfers supporting domestic demand. Eight percent of total remittances are compensations for employees who are on formal employment in overseas market and 3 percent are private capital transfers for churches and an insignificant amount are social benefits.

Remittances in currency is led by the US dollar by 34 percent closely followed by the Australia Dollar by 32 percent with the New Zealand dollar by 29 percent.

Figure 3: Remittances (Annual Total) $million

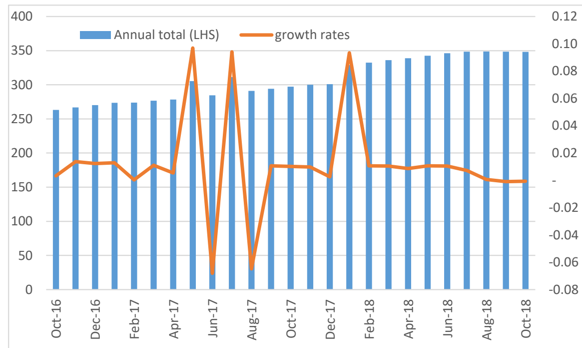
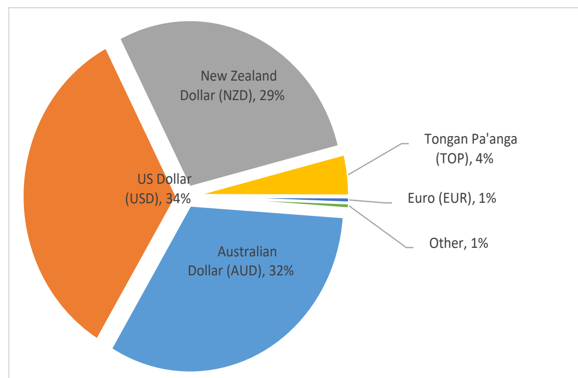


Figure 4: Remittances by Currency (12 months average)



Economic Growth and Real Sector

1. **Agricultural sector real growth has slowed down during the first half of 2018/19.** This is shown by the 12-months actuals of the total agricultural exports in Figure 6. Yam is the top leading exports of roots crops and has shown a lesser amount of export for the second half of 2018 compared to 2017 although December data is not yet available. Refer to Figure 7. The same applies to cassava which is the second leading export of root crops in terms of metric tonnes. Except for export of kava powder, brown coconuts export in the second half of 2018 is slightly lower than tonnes of kava powder exported in 2017.

Figure 5: Total Agricultural Exports (12-months, tonnes)

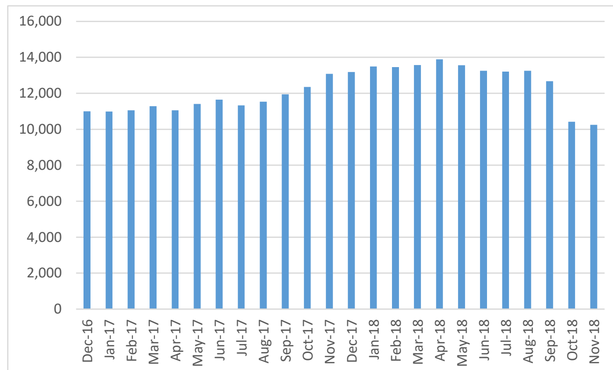
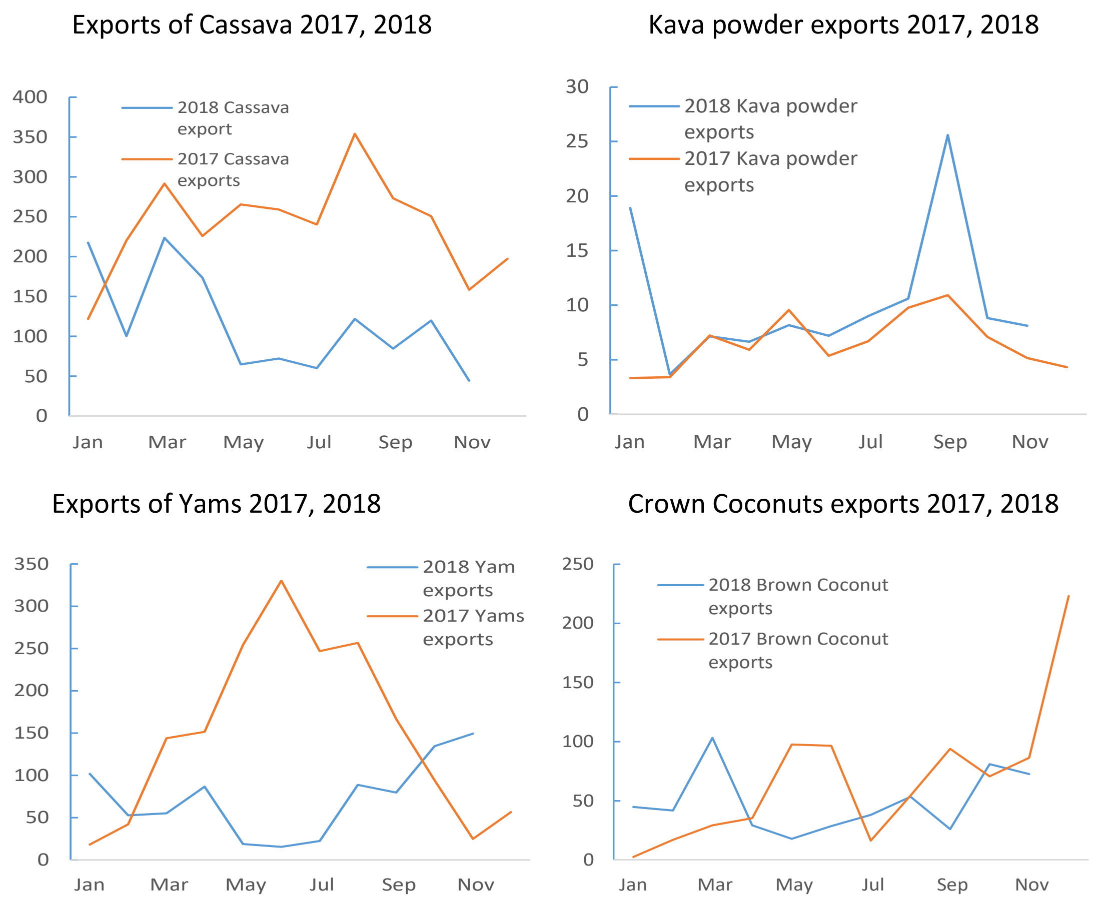
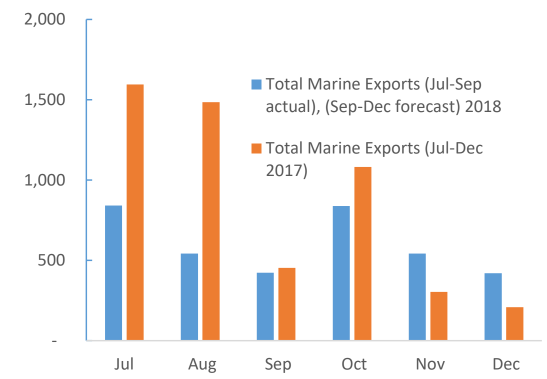


Figure 6: Exports of Root Crops in metric tons



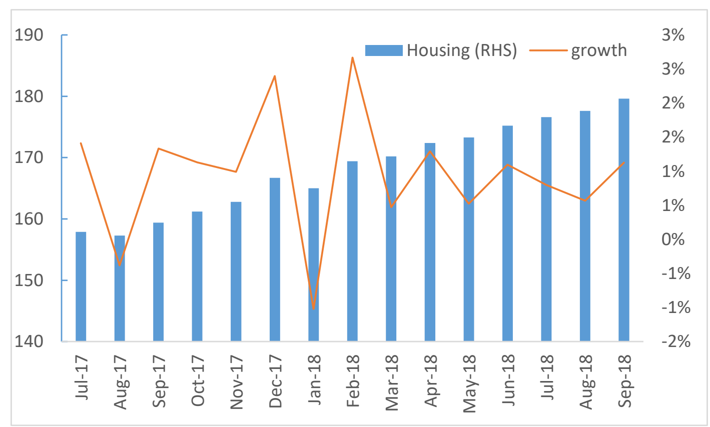
2. **Fishing sector performance is recorded lower in the first half 2018/19 compared to the second half of 2017/18.** The Total Marine export is estimated at a 30 percent lower in the first half of 2018 compared to the same period in 2017. The aquarium exports increased in the second half but not enough to offset the decline in marine exports as aquarium only contributed 14 percent to total fish exports.

Figure 7: Total Fisheries Exports (metric tonnes)



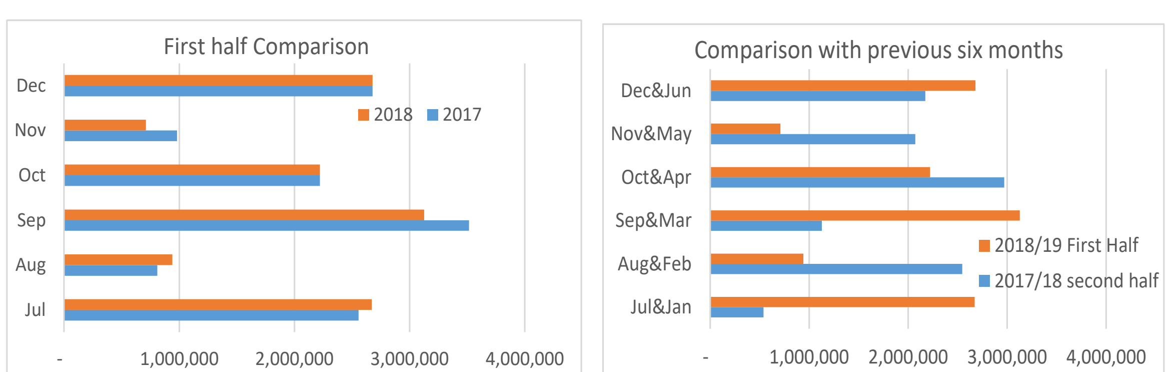
3. **Construction sector continues to dominate the economic activity for 2018/19.** Financial lending continues to grow in the first half of 2018 although depicted a slow start in the first two months of July and August 2018 compared to the momentum shown in June 2018. The donor funded projects including recovery from TC GITA has been rescheduled for December 2019/20 financial year. This reschedule has contributed to the downgrade of the growth forecasted for 2018/19.

Figure 8: House Loan from Financial Institutions



4. **Slightly pick up in wholesale and retail sector for first half of 2018/19.** Wholesale and retail sector has shown a slight improvement in its performance by 0.08 percent compared to the previous six months. The previous six months' activities were affected by the TC GITA. This

Figure 9: Performance of Consumption

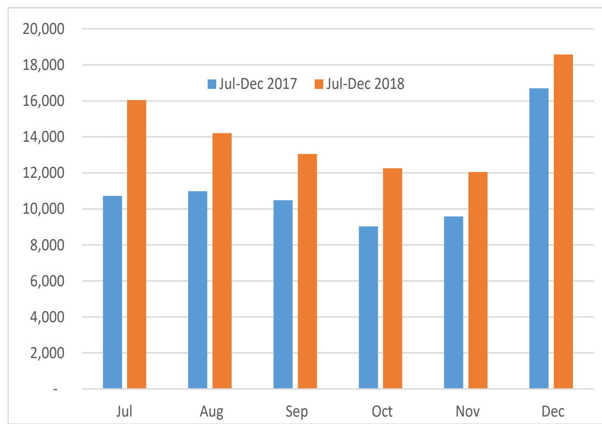


reflects some recovery activities continue in the first half of 2018/19. However, this soft pick up in wholesale and retail overall performance is still lower than the performance of the same period of last year by -0.03 percent.

The month of December 2018 level of performance bypass the level of performance in December 2017 by 12.2 percent marking improved activities in the first half of 2018/19.

5. **Strong growth in the Hotel and Restaurant sector as number of other citizens visited the Kingdom in the first half of 2018/19.** This momentum of growth follows from the same period of last year with an increase of 48 percent. This number includes Tongans who have foreign passports.

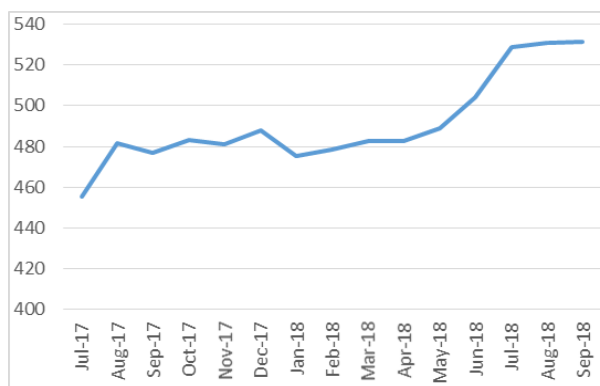
Figure 10: Arrivals in Tonga



6. **Public Administration remained stable although contribute significant to the economy.** Service delivery of the government continues to have an impact in the economy with numbers of civil servants continue to rise as recruitment continues slowly.

7. **Strong liquidity position although shows a slowdown in its growth for first half of 2018/19**. Strong picked up in the previous six months (Jan-Jun 2018) resulted in a healthy banking activities for the first half of this financial year. Net Domestic Credit also depicted an average faster growth rate of 2.3 percent compared negative 0.3 percent average growth rate of previous six months.

Figure 11: Total Liquidity

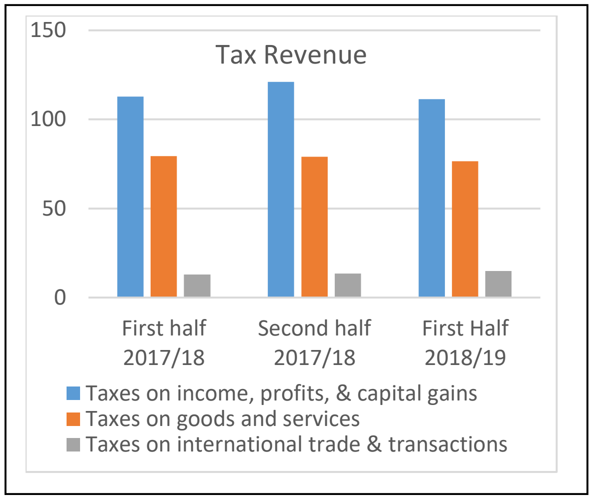


Fiscal Sector

8. **Government presented a fiscal surplus of $20.4 million for first half of 2018/19 compared to $3.5 million surplus and $28.6 million surplus in previous six months and first half of 2017/18 respectively.** The fiscal surplus continues to service government debts except the China loan. The other side of the story on the expenses also reflects slow implementation of recovery activities for TC GITA. The public spending seems distracted from the original expansionary fiscal policy of the government as envisaged in the Budget Statement 2018/19.

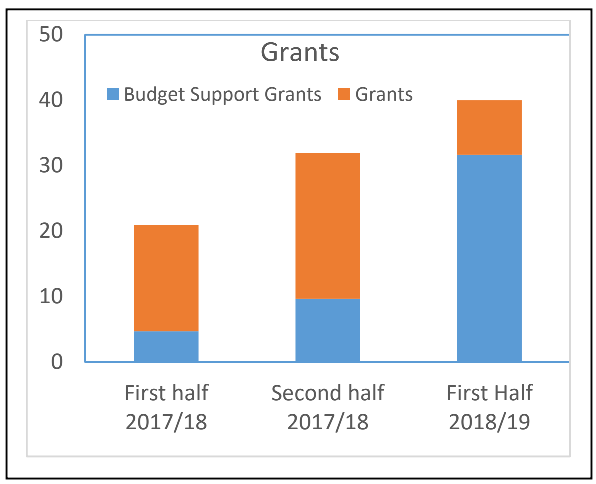
This also reflected a shift in policy direction owing to the fall in domestic revenue of the first half.

9. **The performance of Total Revenue in the first half of 2018/19 is recorded higher than the first half of 2017/18.** This is due to a huge increase in Grants by around 90 percent. Domestic Revenue recorded a fall as major components of taxation declined. Taxes on income, profits & Capital gains declined by 8 percent compared to previous 6 months as Corporate Taxes and withholding tax were both affected by recovering of loss due to TC GITA. Taxes on goods and services dropped by 3 percent and 4 percent compared to the previous six months and first half of 2017/18 respectively.

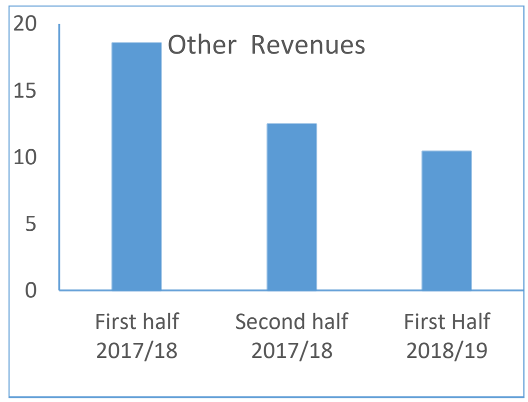


10. **Grant has boosted its numbers in the first half of 2018/19 as budget support of $21.9 million for GITA related activities received in November 2018 from the World Bank and $9.8 million from the European Union.** This amount is the response of donor partners to recovery as planned by Government for TC GITA. The increase in budget support also reflects the Government priority in the recovery. The normal Grant funds for other projects has declined by 62 percent compared to the previous six months with a 49 percent decline compared to the first six months of 2017/18.

    There was $9.7 million budget support received in the second half of 2017/18 with around 70 percent came from Australia.



11. **Other revenues dropped by 16 percent compared to previous six months.** Dividends from Government's businesses increased by 59 percent from previous six months but was not large enough to offset the fall in other revenues. However, this is lower by 49 percent compared to dividends collected in the first half of 2017/18 which is significant in terms of government revenue to achieve its core priorities.



Administraive Fees and charges fell by 15 percents compared to previous six months. This is due to different seasons of collecting revenues. However, compared to the same period of 2017/18, administrative fees and charges slightly fell by 2.5 percent. Ground Handling Fees and Customs Processing fees both declined compared to the previous six months also reflecting decline in revenue collection from taxes on imports.

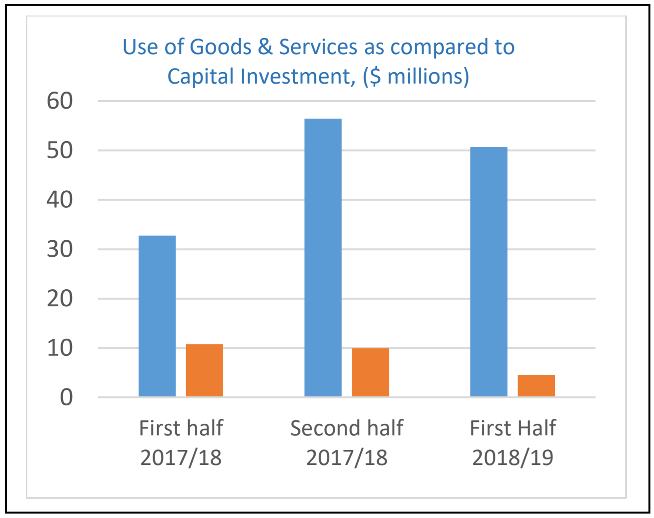
Summary of Fiscal Accounts, 2017/17 and First half of 2018/19

Fiscal ($millions)	First half 2017/18	Second half 2017/18	First Half 2018/19
Total Revenue	**152.3**	**165.6**	**161.7**
Domestic Revenue	131.3	133.6	121.7
Taxation	**112.8**	**121.1**	**111.3**
of which			
Taxes on income, profits, & capital gains	112.8	121.1	111.3
Taxes on goods and services	79.4	79.0	76.6
Taxes on international trade & transactions	12.9	13.5	14.9
Grants	**20.9**	**32.0**	**40.0**
Budget Support	4.7	9.7	31.7
Other revenue	**18.5**	**12.5**	**10.4**
Expense	**112.8**	**152.0**	**136.6**
Compensation of Employees	62.6	64.8	64.6
Use of Goods and Services	32.8	56.4	50.7
Others	17.4	30.7	21.4
Gross Operating Balance	**39.46**	**13.58**	**25.10**
NET ACQUISITION OF NONFINANCIAL ASSETS	**10.8**	**10.0**	**4.7**
Fixed Assets	10.8	10.0	4.5
Non Fixed Assets	0.0	0.1	0.2
NET LENDING(+)/BORROWING(-)	**28.6**	**3.5**	**20.4**
FINANCING	**(28.6)**	**(3.6)**	**(20.4)**
Net Acq of Fin assets	(26.6)	(0.4)	(30.7)
Net Acq of Fin liabilities	(2.0)	(3.2)	10.4

12. **Government expenses fell by 10 percent in the first half of 2018/19 compared to the previous six months led by decrease in Uses of goods and services.** This is much less expansionary relative to the original budget for 2018/19 on the basis of implementation of recovery activities of TC GITA related projects. Compensation of Employees maintain the same level as compared to the previous six months as slow recruitment process continues to keep compensation of employees at the same level.

However, maintaining the compensation of employees with respect to the domestic revenue is on track although drop in domestic revenue in the first half of 2018/19 poses a threat to the planned budget for the government priorities.

13. **Acquisition of fixed assets (Capital Spending) fell significantly in the first half of 2018/19 by 53 percent to $4.7 million compared to the previous six months.** A similar decrease compared to the first half of 2017/18 reflecting the delay in the implementation of reconstruction of shelters and classrooms for those who were affected by TC GITA. However, relative to spending on Goods and Services under expenses, it does not support the fiscal policy of spending on capital investment for deliver long term returns.



14. **Debt service of both domestic and foreign loan continues.** In the first half of 2018/19, Government paid $10 million on foreign loans compared to $8 million paid in the second half of 2017/18. Repayment domestic loans continues on matured bonds. There has not been any repayment on China loan yet and will continue to add pressure in the future.

15. **Fiscal Risks have increase going forward.** The 2018/19 budget statement envisaged a small fiscal surplus of less than 1 percent of GDP with the assumption of budget being fully implemented with a drawdown in cash reserves of $10.8 million. Revenue projections was pessimistic relative to the 2017/18 estimated outturn. However, assuming an 85 percent implementation rate of government funded recurrent spending as well as government funded development spending (based on actual spending versus budget estimates[1]) with underspending amount of around $70 million. Although the surplus contributed to the resilient aspects of building up the buffer in cash reserves but it is in the expenses of economic growth.

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[1] Budget Review 2017/18

16. Risk Assessment Matrix for Tonga

Shock	Likelihood	Impact	Policy Response
Drugs	High	Continue to affect the population, crimes increase, affect health and psychiatric section of Ministry of Health will attract budget request to Government.	Government has established this in its priority aiming at establishing bodies and resources to address this issue.
Downgraded Global growth	Low	May impact the remittances through affected growth of remitting countries.	Macro-Prudent and monitoring so to ease
Delay in implementation of projects	High	Slow economic growth, affect whole population who are depending on these projects.	Central Project Unit has established to address these.
Clime Change/Cyclone	High	Affect the economy	Macroeconomic measures has been put in place to address the resilient of the country in terms of natural disaster.
Change in Legislations	Medium	This will have an impact on the business sector especially the main sectors of the economy.	