



QUARTERLY ECONOMIC UPDATE (JUNE 2015/16)

(August 2016)

**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 GDP deflator has been used as the relevant price level and inflation measure for our forecasts.
 - The fiscal year (FY) of the government ends on 30 June. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2016 ends on 30 June 2016.
 - Forecast period refers to 2015/16 – 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 |
| IMF | International Monetary Fund |
| MT | Metric Tonnes |
| NRBT | National Reserve Bank of Tonga |
| NZD | New Zealand Dollars |
| OET | Overseas Exchange Transactions |
| PAYE | Pay As You Earn |
| TSDF II | Tonga Strategic Development Framework 2015-2025 |
| USA | United States of America |
| WEO | World Economic Outlook |

Table of Contents

OVERVIEW	4
REAL SECTOR	7
PRIMARY	7
SECONDARY	9
TERTIARY	12
FISCAL SECTOR.....	15
EXTERNAL SECTOR.....	16
MONETARY AND FINANCIAL SECTOR.....	17
RISKS	19

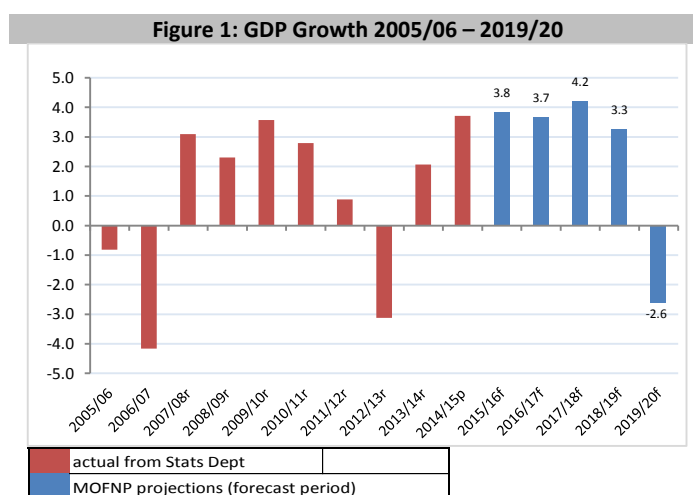
List of Figures

Figure 1: GDP Growth 2005/06 – 2019/20	4
Figure 2: Primary Sector GDP Growth	7
Figure 3: Total Agricultural Production (MT).....	7
Figure 4: Agricultural Exports (MT), quarterly	8
Figure 6: Fisheries Export Volumes (MT).....	8
Figure 7: Public Construction	10
Figure 8: Housing Loans	10
Figure 9: Private Residential and Non-Residential Building Construction, Value of Permits.....	11
Figure 10: Private Residential and Non-Residential Building Construction, Number of Permits	11
Figure 11: Contribution to Secondary Sector Growth	11
Figure 12: Tertiary Sector GDP	12
Figure 13: Wholesales/Retails Trade Sub-sector GDP growth (%)	13
Figure 14: Total Imports (T\$m).....	13
Figure 15: Hotels and Restaurants Sector GDP Growth (%)	13
Figure 16: Tourist Air Arrivals.....	13
Figure 17: Public Administrations/services Sector GDP Growth (%)	14
Figure 18: Transport and Communication Sector GDP Growth (%).....	14
Figure 19: Domestic revenue and Grants	15
Figure 20: Public Expenditure by Main Categories	16
Figure 21: Gross Foreign Reserves vs Imports Cover	17
Figure 22: Annual Inflation Rate	17
Figure 23: Domestic Fuel Prices(end of period)	18
Figure 24: Exchange Rate (period average)	18

OVERVIEW

Global economic recovery is projected to continue in 2016, albeit moderately, and expected to strengthen further into 2017—3.5 percent growth is projected for 2017 from 3.2 percent in 2016 and 2.8 percent in the second half of 2015 (IMF WEO-April 2016). A firming of oil prices, lower capital outflows from China and actively accommodative decisions by major central banks in advanced economies have all contributed to improve global growth sentiment. For the Asia and Pacific region, growth is expected to decelerate slightly to about 5¼ percent during 2016–17, partly reflecting the moderate global economic recovery (IMF Regional Economic Outlook, April 2016). As external demand remains relatively subdued and global financial conditions have started to tighten, domestic demand, particularly consumption, propelled by lower commodity prices, rise in disposable income, along with macroeconomic stimulus in some economies are expected to be the major drivers of activity across most of the Asia and Pacific region. The global and regional outlooks will without doubt impact positively on the outlook for Tonga in coming years.

GDP growth for 2014/15 was estimated at 3.7 percent, far higher than the 2.1 percent rate witnessed in 2013/14. This improved growth rate was due mainly to strong performance in the agriculture sub-sector, particularly from root crops, despite the 2014 drought that negatively affected agricultural output. Growth in 2014/15 was also supported by strong performance in the secondary and tertiary sectors; mainly from construction, tourism and the preparations for the coronation event of 2015. Growth estimates for 2015/16, and for the first four years of the forecast period, are to remain strong, around the same level as in 2014/15. Sharp drop to negative growth rate (-2.6%)—around the average growth of 2.5 percent over the 2015/16 to 2019/20—is expected at the end of the forecast period.



GDP growth for Tonga is projected at around 3.8 percent in 2015/16, slightly above the 3.7 percent rate for 2014/15 and stronger than our previous forecasts included in the Budget Statement 2016/17. The slight increase is driven by growth in tertiary sector activities—wholesale and retail trade, hotels and restaurant and transport and communication—given the collective effects of the Tupou College 150th Anniversary in June 2016, and the Coronation event of July 2015. The positive performance of the tertiary sector is also boosted by the strong growth in public administration and services. The secondary sector’s contribution to overall GDP growth derive from increased level of construction activities, particularly with the commencement of two new projects—the St. George building complex and upgrading of the Fuaa domestic wharf during the year. We estimate that growth in the secondary sector will continue; driven by public construction projects and increases in private construction activities—residential and non-residential. As expected, the slight growth in the primary

sector is an indication of recovery from the drought that caused a decline in agriculture production in 2014/15.

As highlighted above, the outlook for outer years in the domestic economy is positive and strong. The preparation for the Pacific games in 2019 will boost construction activities; it is expected too that heightened level of domestic activities during the games will lead to sharp increases in domestic demand for consumer goods, leading to further growth in wholesale and retail trade and in demand for hotel and restaurant services. Furthermore, growth projections for the primary sector in the outer years is supported by the efforts aimed at improving market access, diversify agricultural product exports, as well as anticipated positive effects from other initiatives for growth in the Agriculture and Fisheries Sector Plans. Rather subdued growth estimate for the secondary sector in the outer years is mainly due to the expected decreases in construction activities as the Pacific Games related construction comes to an end. Stronger real growth combined with weaker inflation leads to higher nominal GDP. All else equal, higher nominal GDP would also tend to lead to lower debt ratios.

Annual rate of inflation for the year ended June 2016 was 0.1 percent. This reflects developments in the global oil market that had witnessed significant drop in oil prices since August 2014 through to the first half of calendar year 2016. This translated into lower domestic prices for petrol and diesel, as well as for electricity. Global food prices have also moved in the same direction as global oil prices; declining to around the lowest level in the past 6 years. However, shortages in the supply of kava associated with the El Nino and local drought conditions have counteracted some of the expected gains in decrease in food prices on the domestic economy. For the rest of the forecast period, inflation is expected to remain relatively low. Gradual but relatively subdued increases in prices may be expected in coming years as global oil and food prices rebound and supply conditions normalize.

There are a number of key risks, both from external and domestic sources to our economic forecasts. Primary sector is extremely vulnerable to natural hazards. In particular, weather conditions remain a high risk for agriculture sector even though our forecast assumes that the level of production will recover to normal level in 2015/16 through to the end of the forecast period. However, a tropical cyclone or any unfavourable weather condition that occurs in the near-term would pose a risk of lower production in the primary sector. For the secondary sector, the risk to our forecast of strong growth could stem from a scale down in the size, delay or cancellation of major construction project(s). The result could lead to overall weaker growth through the forecast period. Tongan economy is also heavily reliant on external income in the form of donor aid and remittances. Hence the economic conditions in Australia, New Zealand and the USA for instance are very crucial as these would pose a risk if it does not improve or remain as expected (ADB – Pacific Economic Monitor, July 2016); the remittances, tourist arrivals and demand for exports will be negatively affected. A sharp increase in the global commodity prices that are currently assumed to be fairly stable and to rise only gradually thereafter over the forecast period, may lead to increases in costs of production, drive up inflation and reduce household real incomes. On the domestic front, the revival of the strong credit growth could threaten our financial stability somehow the banking

sectors remain highly liquid. The current level of outstanding housing loan has already reached the 2009 level of non-performing loans (by businesses) as indicated in Figure 8 below. This could pose a risk for the banking sector that may require governmental bail out measures. The increasing trend of government current expenditure, wage bill in particular, poses another threat to the budget balances which could lead to higher public debt and a risk to debt sustainability.

The improved tax administration and increased excise tax are clearly reflected in the higher level of domestic revenue collected at the end of June quarter 2016. Provisional figures indicate that both domestic revenue and cash grants increased by 20 percent compared to the 29 percent recorded for the previous quarter and same period a year ago. The increase could be attributed to improvements in compliance from businesses and the effects of enhanced activities in the tertiary sector that boosted imports. Increases in receipts due to budget supports received from the Government of Australia, Asian Development Bank and World Bank during the review quarter also played a role. The domestic revenue collected at the end of the review quarter was 30 percent higher than the revised budget estimates for the year from tax items particularly from corporations and businesses, excise tax, import duties (business), CT imports, customs & other import duties and PAYE.

Seasonally, government expenditure is usually stronger in the June quarter, being the last quarter of the fiscal year, compared to March quarter—all payments incurred in the fiscal year are usually settled before end of the fiscal year. Provisional figures indicated that government expenditure increased by 9 percent in June quarter year-on-year and 26 percent higher than in the previous quarter. This was mainly due to increase in payments of compensation of employees; a reflection of the increase in number of government employees due to the requirement to fill vacant posts for level 9A and below before the recruitment freeze at the end of March quarter. Other contributory factors are increases in payments for goods and services, grants and subsidies. The total expenses for the review quarter contribute 24 percent to the revised budget estimates.

Foreign reserves at the end of June 2016 reached a new record in the history of Tonga; \$354.9 million and 10.1 months of import cover. The increase in foreign reserves reflects the increased public and private transfers. This import coverage is more than double of the minimum range of 3-4 months of import cover set by the National Reserve Bank of Tonga.

The improving global economic environment support robust domestic economic activities and growth. IMF projection for global growth is around 3.1 percent in 2016—a sign of global rebound over the 2015 estimates. Global growth is projected to further strengthen in 2017 and beyond, mainly driven by emerging markets and developing economies assuming that conditions in China and other advanced economies start to gradually improve and normalize. Global growth is expected to stabilize at around 3.4 percent in the outer years. IMF also projected a moderate growth for Tonga's main trading partners—Australia, New Zealand and the United States—throughout the forecast period. Stronger conditions in these countries will continue to support remittances to Tonga; increases in the number of people participating in seasonal workers schemes, and increase demand for Tonga's exports will follow suit.

REAL SECTOR

PRIMARY

GDP growth for the Primary sector in 2014/15 was negative 2.7 percent; largely a reflection of the drought that affected agriculture output during the year. This is despite the good performance in the fisheries and forestry subsectors. Positive growth is expected for 2015/16; assumes that the drought condition is over and level of production in the agriculture subsector is expected to expand. Moderate growth is also projected for the outer years.

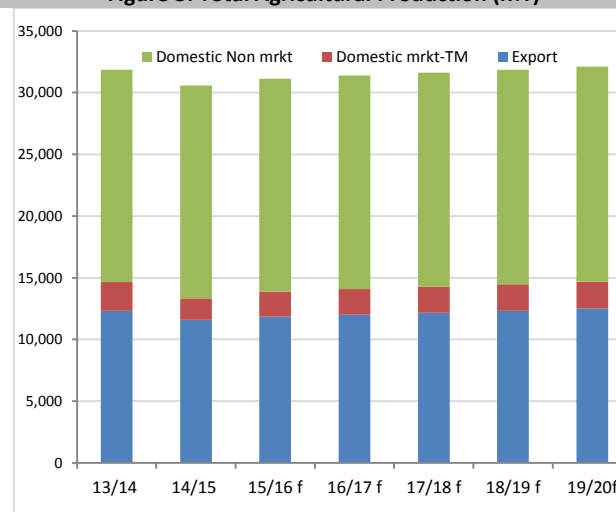
Figure 3 shows that level of total production, exports and domestic (market and non-market production) declined by 4 percent, 6 percent and 3 percent respectively in 2014/15 compared to the level of production in 2013/14. The major decline were in exports of squash (down by 42 percent), taro and pele leaves (down by 38 percent), vegetables and fruits (down by 14 percent) and root crops (down by 2 percent). On the other hand, exports of other agricultural products including kava, vanilla and others increased by 2 percent. For 2015/16, provisional data (data for the first three quarters) indicate a significant increase in the volume of squash export by 71 percent, higher than the volume (3,762.6 MT) for whole of 2014/15.

Figure 2: Primary Sector GDP Growth



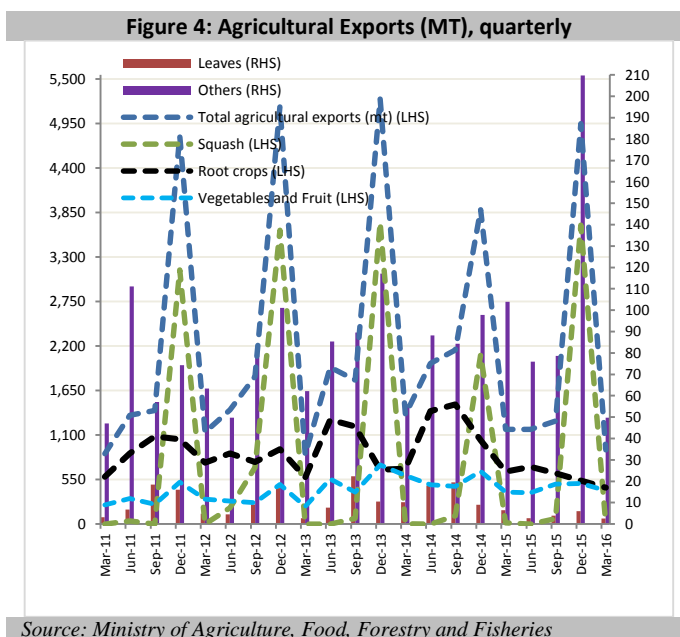
Sources: Statistics Department and Ministry of Finance and National Planning

Figure 3: Total Agricultural Production (MT)

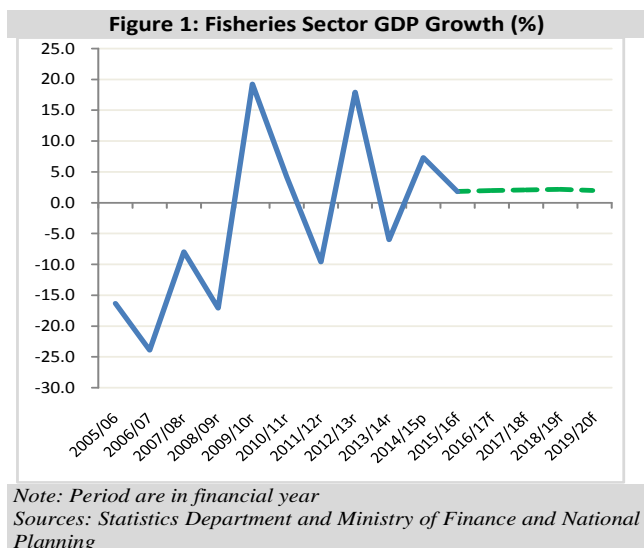


Source: Ministry of Agriculture, Food, Forestry and Fisheries

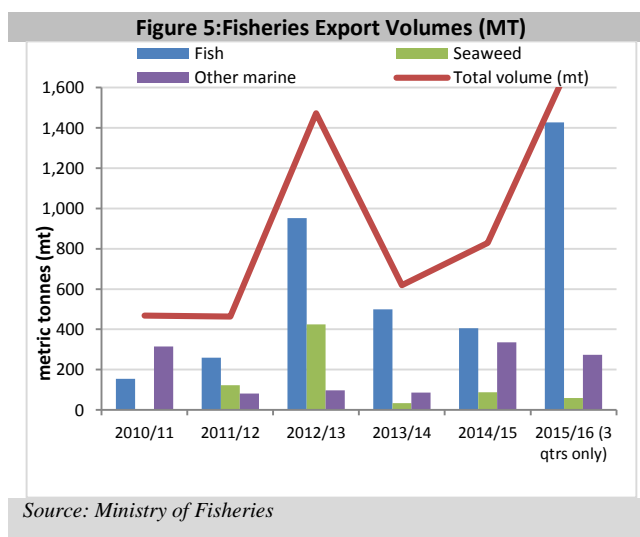
Figure 4 illustrates the quarterly trends of agricultural exports. It shows that squash remains our primary export and continues to drive the growth trend of total agricultural exports; its share of total exports remain at about 67 percent on average during the December quarters - peak seasons - in the past six years. The other export items are root crops (with an average of 51.2 percent), vegetables & fruits (with an average of 24.2 percent), other agricultural export products including kava products, vanilla, coconut (classified as various products), others (with an average of 4.8 percent), and taro and leaves (with an average of 0.5 percent).



Growth in the fisheries subsector is estimated to continue at its positive trend of 2014/15, but weaker, through to the end of the forecast period. This growth momentum is driven by increase in the number (from 2 to 4) of local fishing vessels that will expand cargo capacity and other administrative reforms being undertaken by the Ministry of Fisheries including the revised Fisheries Act and other growth enhancing policies.



Performance in the Fisheries industry had significantly improved over time as reflected in the positive growth of 7.4 percent in 2014/15 against the negative growth of 6 percent in 2013/14. Total volume of fisheries products exported in 2014/15 grew by 209 MT (34 percent) compared to 2013/14. Export of other marine products also expanded by over 150 percent, seaweeds (by over 280 percent) and tuna (by 8 percent). For 2015/16, provisional data, for the first three quarters only, indicates a further increase (by more than 110 percent or 929



MT) in the total volume of fisheries exported compared to the full year data for 2014/15. This increase was driven by a strong increase in tuna exports (by over 300 percent) and also supported by the increase in the exports of snappers (by over 100 percent) and sharks (by over 250 percent).

The Forestry sector is expected to continue its positive growth trend over the forecast period. Potential for positive growth in the subsector rests on the export of sandalwood as many of them reached maturity stage having been planted in the past years. Positive growth for the subsector is also supported by the expected increase in the production of electricity poles for both exports and the domestic market. The new work plan for the forestry products company would also be a key driver of improved performance.

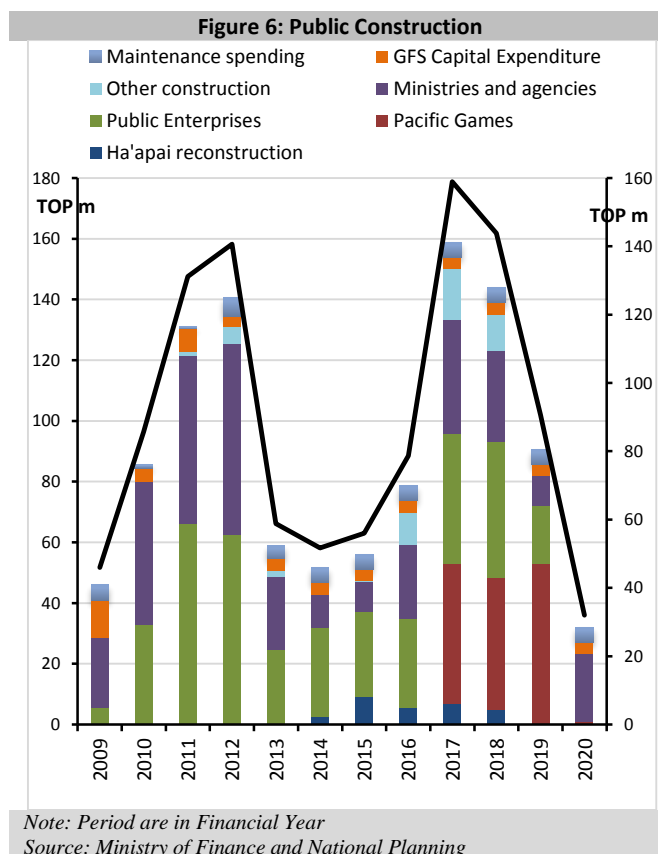
The overall outlook for primary sector is positive and anticipated to grow at around 2 percent on average from 2015/16 through to the end of the forecast period. Anticipated increases in utilization of the Agricultural Market Fund and Fisheries Development and Export Fund could also support enhanced activities in the subsectors. Positive growth in the agriculture subsector continued to be driven by various initiatives for improvement in the market access, improving access to the Agricultural Marketing Fund, improving procedures and quarantine issues for the export pathways. The provision of the extra resources, as stated in the TASP 2016-2020, to keep unwanted pests and disease from entering Tonga and other measures such as better roads to farm areas will have positive impacts.

SECONDARY

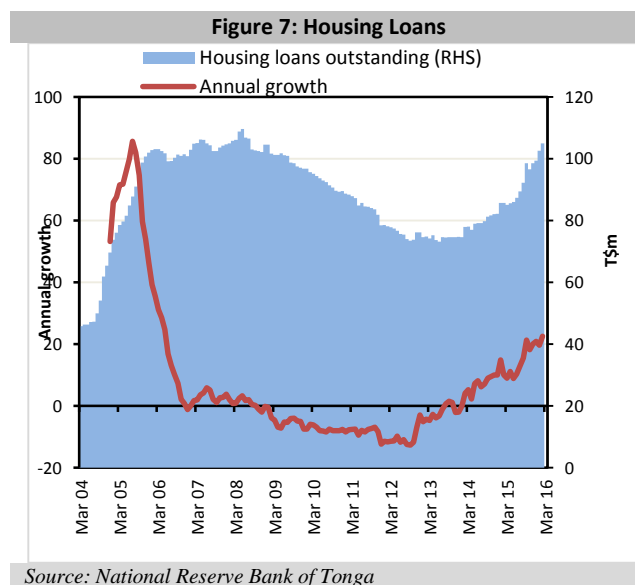
Growth for the secondary sector is forecasted to slowdown to 6.9 percent in 2015/16 compared to 10.9 percent in 2014/15. Growth is then expected to further strengthen to 15.4 percent in 2016/17 before declining rates set in towards the end of the forecast period. The average growth rate for the forecast period is 4.9 percent which is only 4 points percentage higher than the average of 4.5 percent growth of the past 10 years.

The slowdown in growth estimated for 2015/16 is largely due to the delay in commencement of some major projects initially planned—extension of fibre optic cable line to Vava'u and Ha'apai islands and the preparation for the Pacific Games—as well as some construction activities that were put on hold due to land issues (some components of the Ha'api Reconstruction project for instance). Manufacturing and electricity and water supply are both forecast to grow around the average rate of 0.2 percent and 1.9 percent respectively as experienced in the past ten years to 2014/15.

Positive growth is expected for the construction sub-sector in 2015/16, but slower compared to 2014/15. The commencement of the two new donor-funded projects; the St. George building complex and upgrading of the Fua domestic wharf, in addition to the number of ongoing projects such as the Tonga Transport Sector Consolidation Project, Ha’apai Reconstruction, Extension of the submarine cable to Vava’u and Ha’apai, and the Tonga Village Network Upgrading Project and others, have contributed to positive growth estimated for the year. However, growth for construction subsector was slower in 2015/16 than expected compared to 2014/15 was due to further delays in commencement of construction related activities to the Pacific Games and some components of Ha’apai reconstruction project.



Growth in public construction is anticipated to further strengthen in 2016/17 due to additional projects anticipated to begin soon including phase 2 of the Aviation projects for upgrading of Fua’amotu and Lupepau’u runways, extension of fibre optic cable to Vava’u and Ha’apai islands and extension of the solar farm project to the outer islands. Construction activities as part of the preparation for the Pacific Games are anticipated to start in 2016/17. This will provide a further boost for construction activity through the outer years of the forecast period. However, as experienced in 2012/13, completion of these construction activities towards the end of the forecast period may lead to negative outturn.

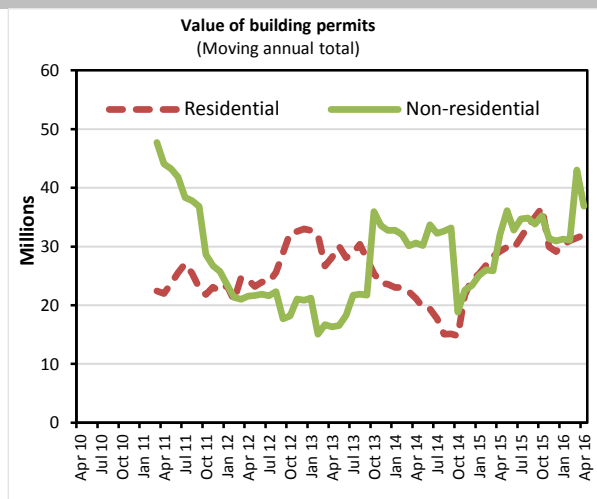


Private residential construction is forecast to increase supported by the increasing trend shown by the latest available data for the first three quarters of 2015/16, for both value and annual growth of housing construction permits. In Figure 8, outstanding housing loan is showing a high level of activities going on in the construction sector. The level at the end of

March 2016 has already reached the level of total credit in March 2008 where the financial institutions were deeply affected by the increasing of non-performing loans, which is somewhat a call for policy attention as a precaution.

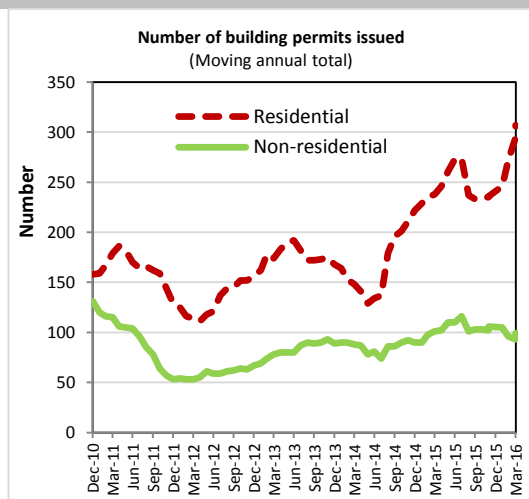
Private non-residential building construction is estimated to slightly fall compared to previous quarter, but higher than corresponding period a year ago, as indicated by the most recent quarters for both value and number of permits.

Figure 8: Private Residential and Non-Residential Building Construction, Value of Permits



Source: Ministry of Infrastructure

Figure 9: Private Residential and Non-Residential Building Construction, Number of Permits



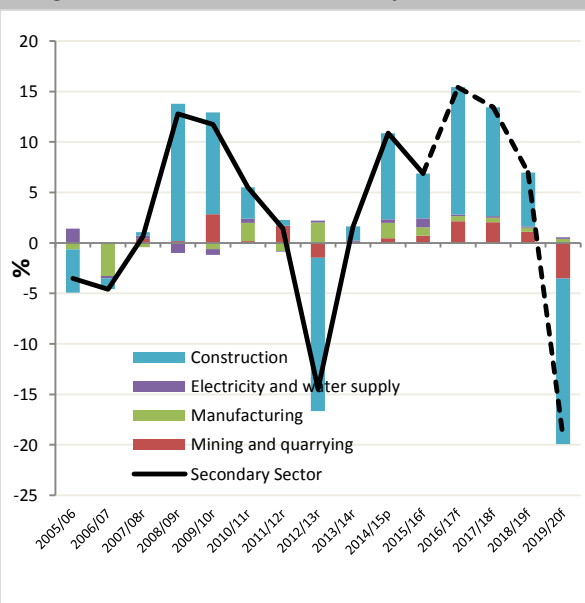
Source: Statistics Department

The other general indicator that supports forecast for the construction sector is the increase in import of construction materials.

The positive growth anticipated for 2015/16 was supported by the increase in number of tourist arrival as well as increase in number of cruise ships arrived in Tonga and the estimated increase in the consumption tax (CT) returns from manufacturing businesses.

Growth for the secondary sector is expected to further strengthen in 2016/17 given the number of projects that are expected to commence during the year including the expected extension of fibre optic cable to Vava'u and Ha'apai islands as well as the expansion of solar farm project to outer islands as well as the Pacific Games related construction activities that will start during the year. The outlook for the rest of the forecast period is for a gradual decline in growth for a couple of years before reaching negative rates at the end of the forecast period. The expected

Figure 10: Contribution to Secondary Sector Growth



Sources: Statistics Department & Ministry of Finance and National Planning

completion of all the Pacific Games related construction projects is the major factor in the negative growth expected for end of forecast period.

TERTIARY

Growth over forecast period for the tertiary sector is continued to be largely influenced by one-off events, potential impacts on tourism sector and developments in the government sector. Firstly, the two one-off events in 2015/16 — the Coronation in July 2015 whose effect shown is manifested in the 2014/15 estimates and further in the beginning of 2015/16 — and the Tupou College 150th Anniversary in June 2016 which caused an increase in the demand for wholesale & retail trade of goods. The commencement, in 2016/17, of related activities anticipated leading on to another one off event in August 2019 - the Pacific Games are also contributed to the increase expected for the services sector. Secondly is the potential growth in tourism sector output associated with the effects of these events. We anticipate increases in the demand for hotel and restaurant, transportation services and so forth in this regard. Lastly, growth estimates for public administration/ services are likely to be impacted by the public sector recruitment policies. Recruitment of posts at level 9A and below was frozen in March 2016.

The growth for the tertiary sector is expected to further strengthen in 2015/16; moderate slowdown is projected for 2016/17. An upturn is expected for a couple of years thereafter before stabilizing at about 2 percent on average at the end of the forecast period. The average growth rate for the forecast period is 2 percent, higher than the historical average of 0.9 percent.

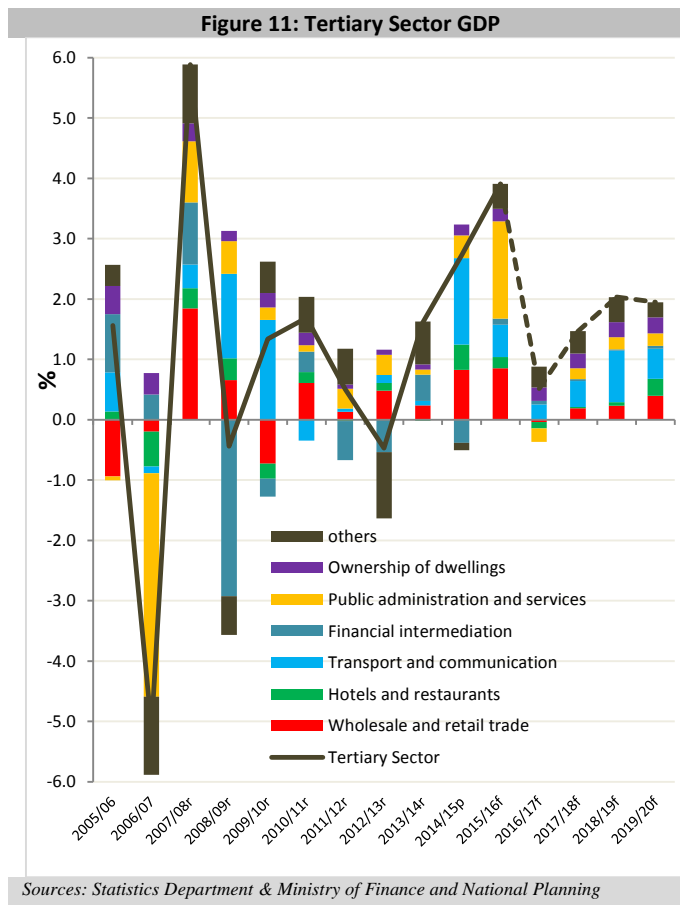
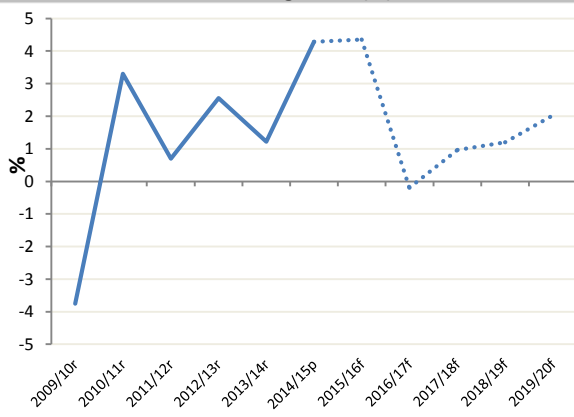
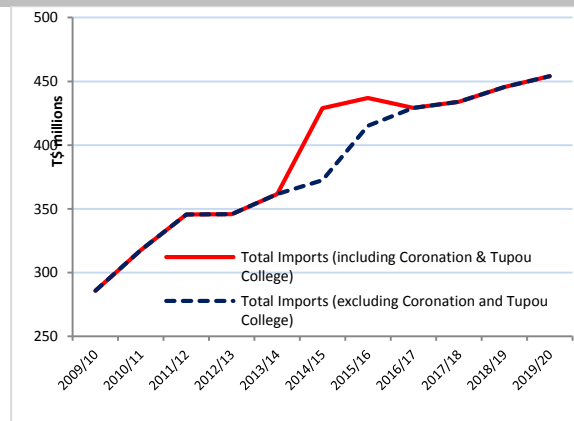


Figure 12: Wholesales/Retails Trade Sub-sector GDP growth (%)



Sources: Statistics Department and Ministry of Finance and National Planning

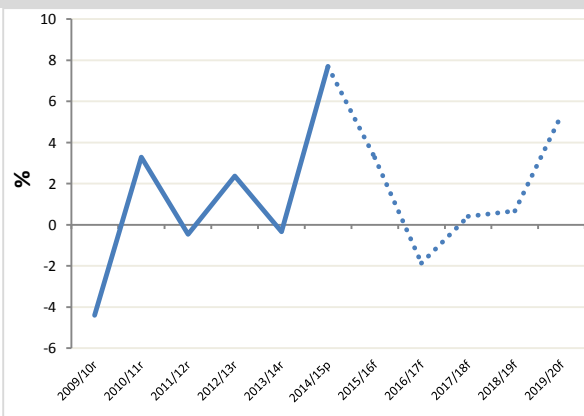
Figure 13: Total Imports (T\$m)



Sources: Statistics Department and Ministry of Finance and National Planning

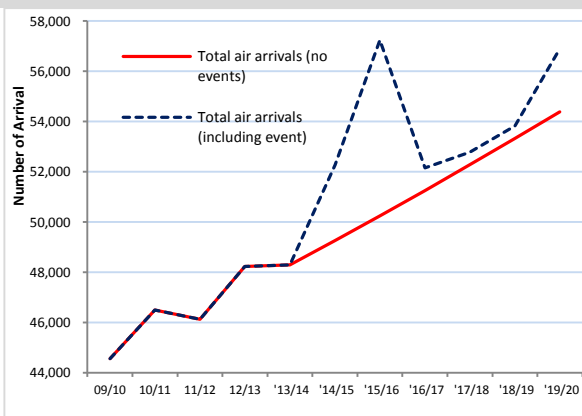
The July 2015 Coronation activities created an increased demand for hotels and restaurants services in 2014/15 and the beginning of 2015/16. Additionally were effects of the Tupou College 150th Anniversary at the end of 2015/16. The boost in demand for services is manifested in the 8.2 percent increase in the number of tourist arrivals by air in 2014/15 compared to 2013/14. This is expected to further increase by 9.5 percent in 2015/16 compared to 2014/15. Similarly, the number of returning residents was higher in 2015/16 compared to 2014/15. However, the impact of returning residents on the demand for hotels is expected to be lower as many are likely to be Tongans and who would prefer to stay with relatives and friends. Hence, the growth expected for this subsector is to decline compared to 2014/15 and forecast a negative growth for the subsector in 2016/17 and expected growth to gradually increase assuming that demand will fall back to more or less around the underlying growth rate of 0.7 percent (trend levels) for couple of years, then strengthen back towards the end of the forecast period. The positive outlook for the subsector is also enhanced by the potential increases in available hotel rooms with the expected opening of the Tanoa Hotel during the first half of 2016/17. So also will the potential rise in Tonga’s profile on the tourists destination map occasioned by Pita Taufatofua during 2016 Olympic Games in Rio de Jenairo, Brazil and as well as the coming 2019 Pacific Games.

Figure 14: Hotels and Restaurants Sector GDP Growth (%)



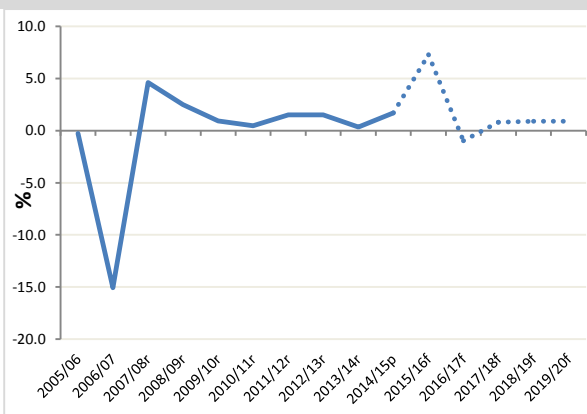
Sources: Statistics Department & Ministry of Finance and National Planning

Figure 15: Tourist Air Arrivals



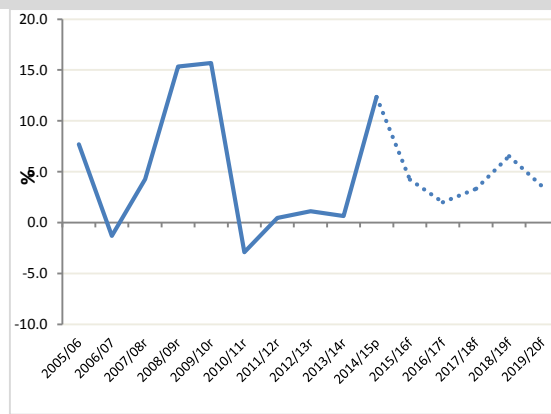
Source: Statistics Department & Ministry of Finance and National Planning

Figure 16: Public Administrations/services Sector GDP Growth (%)



Sources: Statistics Department & Ministry of Finance and National Planning

Figure 17: Transport and Communication Sector GDP Growth (%)



Sources: Statistics Department & Ministry of Finance and National Planning

The public administration and services subsector is projected to increase significantly in 2015/16, consistent with increases in the number of government employees by 8.0 percent compared to 2014/15. The recruitment policy agreed in 2014/15 was expected to be implemented in 2015/16 but is being delayed and only become effective in 2016/17. The policy makes provision for additional recruitment at level 9 and above and freezes any recruitment below level 9. Negative growth is expected for the subsector in 2016/17 on the assumption that the recruitment freeze will be in place during the period. Growth estimates for the subsector outer years is projected to remain stable at a low rate.

Growth in the transport and communication subsector is anticipated to be higher in 2015/16, due in large part to the increase in demand for the services created by both the Coronation activities at the beginning of 2015/16 and the Tupou College 150th Anniversary at the end of the same financial year. This is evident in the increase in the number of flights per week around both the events. The subsector has also been boosted by the new direct flight between Fiji and Vava'u that became operational two months before the Tupou College's celebration. It was also evident in sea transport as the numbers of cruise ships arrivals increased significantly. The growth outlook for the subsector is positive; an average growth rate of around 3.9 percent is projected for the outer years based on the assumption that all ongoing and planned infrastructure investment projects are completed as they would help boost both transport and communication services as they become more operationally efficient. Some of these projects include upgrading of Fua'amotu and Lupepau'u airports, the proposed new ship that will operate (on an interim basis) and cater for the demand for services between Tongatapu and the outer islands and the extension of fibre optic cable to outer islands (Vava'u and Ha'apai).

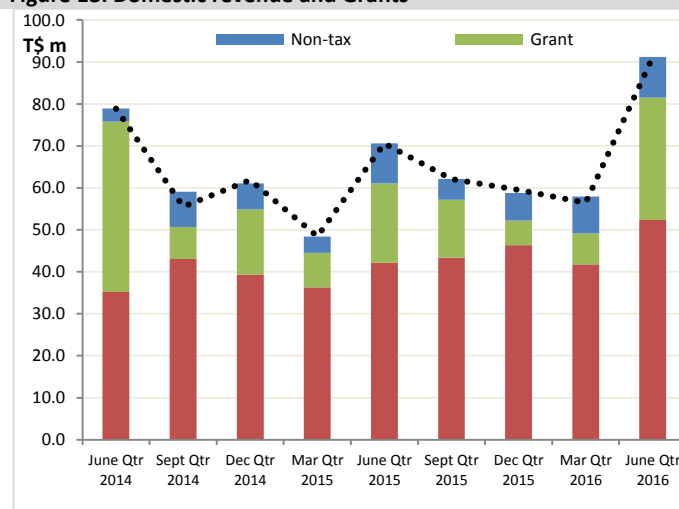
Other issues related to the financial intermediation sub-sector. A word of caution in this regard is that the threat of closure by some of the Money Transfer Operators (MTOs) may impact negatively on remittances. Globally and in the Pacific region, remittances transmitted through the MTOs have become the major channel used by a large majority of overseas workers—Tongan overseas for instance—to send money back home. Services provided by the MTOs are much cheaper compared to banks and other larger financial institutions.

However, efforts aimed at combating money laundering and terror financing (AML/ CTF) globally and in the Pacific, de-risking by international financial institutions that are associated with the closure of MTOs had increased the cost of remittances. Remittances play a significant role in household income and livelihood of Tongans and the Tongan economy as a whole. Hence there is the need to draw closer policy attention and scrutiny at this issue during the Pacific Forum Economic Ministers Meeting and the relevant authority in Tonga.

FISCAL SECTOR

In June quarter 2016, total revenue and grants were estimated to grow by 29 percent from the same period in June 2015, due mainly to a 20 percent increase in domestic tax revenue and non-taxation receipts of around 54 percent from donor grants. On quarterly basis, total revenue and grants received in June quarter 2016 were around 62 percent higher than the previous quarter. The increases in both annual and quarterly receipts were mainly due to increases in corporate tax from small businesses (135%), excise tax (52 %), corporate tax from large businesses (40%), business import duties (38 %), corporate tax from large businesses (around 35 %), CT from imports (34 %), customs and other import duties (32 %), PAYE (31 %), and motor license & registration (7%). Domestic revenue collected at the end of June 2016 contributes around 30 percent to the revised budget estimates for 2015/16. Furthermore, cash grants receipts in the June quarter 2016 were significantly higher (more than three times) compared to previous quarter due to the receipts of \$15.4 million as budget support—\$6.4 million from ADB, \$6.5 million from the Government of Australia and \$2.5 million from the World Bank.

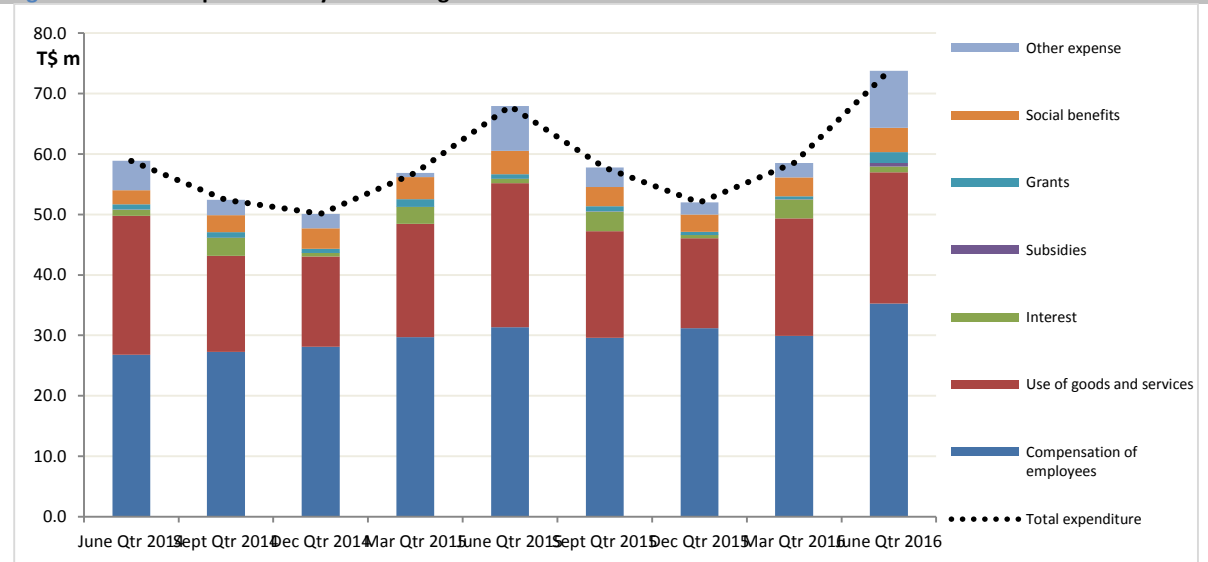
Figure 18: Domestic revenue and Grants



Source: Ministry of Finance and National Planning

Provisional data indicates that government expenditure for June quarter 2016 are 26 percent and 9 percent higher than the previous quarter and same period a year ago respectively. The quarterly increase was mainly due to increases in the compensation of employees (by about 18 percent) reflecting the increase in number of government employees, increase in expenditure on goods and services (by 12 percent), grants in terms of contributions to overseas organizations (by 277 percent), subsidies (by 2195 percent) to development committees and social benefits (by 27 percent) due to social welfare scheme and vulnerability and pensions & gratuities.

Figure 19: Public Expenditure by Main Categories



Source: Ministry of Finance and National Planning

The increases in payments for goods and services that account for the quarterly upward trend were due to the increase in expenditure on utilities, domestic and overseas travel, freight and maintenance expenses (office equipment, vehicles and buildings). The increase in the expenses for June quarter is seasonal as all payments accounted for in during the financial year must be paid out before end of June 30th of every year. The total expense for June quarter 2016 contributes 24 percent to the revised budget estimates for 2015/16. Most expenditure items were well below the revised budget estimates except for subsidies that were about 100 percent higher than the budgeted amount.

EXTERNAL SECTOR

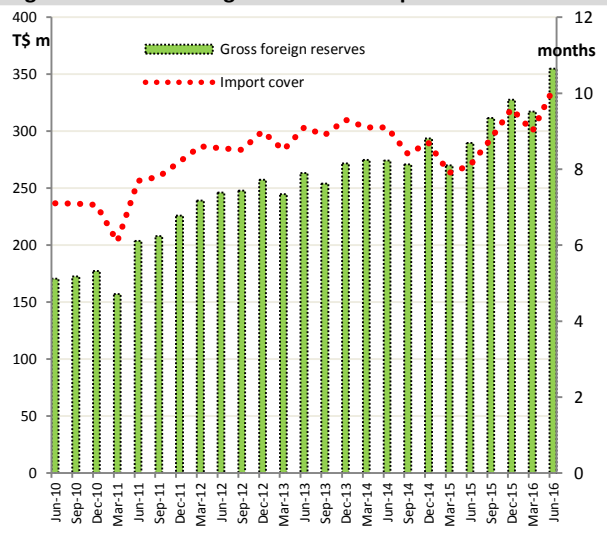
The expected earnings from export at the end of June quarter 2016 could be lower when compared to the previous quarter; moreover, year-on-year, it could be higher than corresponding period in 2015. The increase in annual trend could be supported from the observed increase in fish and other marine exports, mainly tuna, snapper and other aquarium exports. Receipts from agricultural exports may be lower than expected. The Overseas Exchange Transactions Trade balance account for the June quarter is assumed to remain favourable due to higher imports and higher Transfer balance. Increase in remittances and other official transfers associated with above mentioned events are the push factors for higher transfers.

Import payments are anticipated to increase at the end of June quarter 2016 in line with growth projection for wholesale and retail trade. This is due to increase in demand for goods and services associated with the events during the review quarter; the celebrations of the Queen Mother's 90th birthday and the Tupou College 150th Anniversary. Growth in the demand for construction materials is also anticipated to spur import payment for the review quarter; a lot of construction activities are currently ongoing and many expected to start in the near term.

The outlook for the current account of the BOP is for a slowdown in deficit in the near term due to fall back in import demand to more normal level after these one-off events and positive prospects for exports from both Agriculture and Fisheries.

The level of gross foreign reserves reached a new record at the end of June 2016; it was \$354.9 million and represents 10.1 months of import cover. This was around 12 percent higher, by \$37.6 million, compared to previous quarter and around 23 percent or \$65.2 million higher than what was recorded for June 2015. The increase on quarterly basis was mainly due to higher receipts of budget support in addition to foreign aid during the review period. The 10.1 months of import cover for this level of gross foreign reserves implies that the country is in a comfortable external position that far surpasses the minimum range of 3 – 4 months set by the NRBT.

Figure 20: Gross Foreign Reserves vs Imports Cover

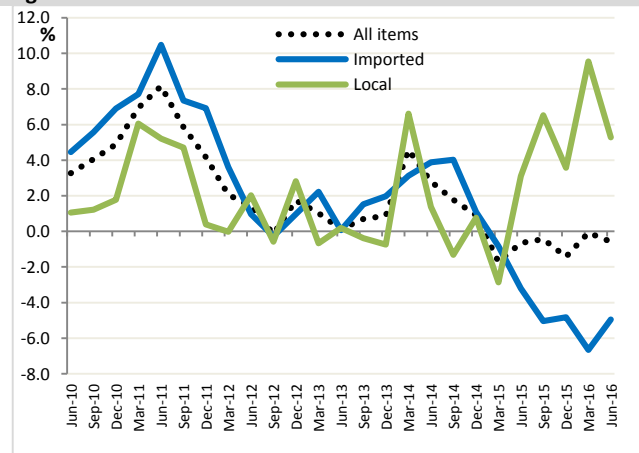


Source: NRBT

MONETARY AND FINANCIAL SECTOR

The annual inflation rate at the end of the June quarter 2016 was 0.1 percent compared to a deflation of 1.0 percent in the previous quarter and 0.2 percent in June quarter in 2015. The changes were mainly driven by a combination of decline in the prices of imported items - mainly food, and increases in local prices – food and kava Tonga. The continuing declines in the price of imported items, mainly under food and transportation categories, reflect lower global oil and food prices. The increase in the local prices has been due to significant increases in the prices of kava, fruits & vegetables, meat, fish & poultry.

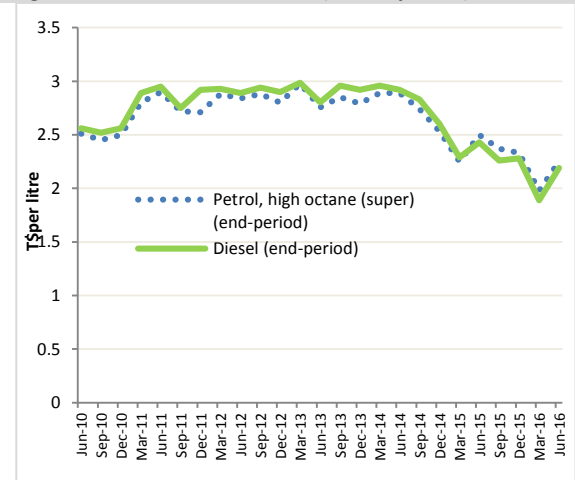
Figure 21: Annual Inflation Rate



Source: Tonga Statistics Department

Domestic oil prices (both petrol and diesel) at the end of June quarter 2016 were lowered when comparing to same period a year ago but higher compared to previous quarter. Lower prices on year-on-year basis were in lined with the lowered global oil price index. On quarterly trend, the increases were due to the recent upsurge in global oil prices and Singapore refined petrol prices over the quarter, although the depreciation of the pa'anga and higher cost of freight offset some of the price decline. This is consistent with higher imported price for the Transportation and Household Operations (up by 3.1 percent) components of the CPI at the end of June quarter 2016.

Figure 22: Domestic Fuel Prices(end of period)

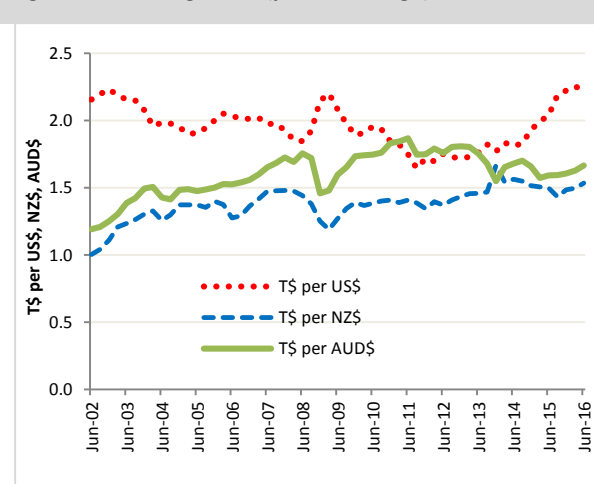


Source: Competent Authority, Ministry of Labour, Commerce and Consumers

The outlook for inflation for the rest of the forecast period is anticipated to be persistently low; gradual increases through the forecast period may however be witnessed if supply conditions normalize in the global oil market; a situation that may result in moderate increase in oil prices. However, there is still substantial uncertainty about the outlook for global commodity prices following geopolitical risk in the oil producing countries and subdued aggregate demand growth. Changes in the global market could manifest in the domestic market and impact on our projected outlook for the medium term.

At the end of June 2016 quarter, the period average for Pa'anga appreciated against the New Zealand dollar and Australian dollar; it however depreciated slightly against the US dollar compared to previous quarter. This movement is due to changes in trading partners' economies; falls in global commodity prices have affected the values of the NZD and AUD. The USD has been appreciating as the economy strengthens and possibilities and amidst speculation of a rise in the Fed rate. The Pa'anga depreciated against the US Dollar from an average of T\$2.04/\$1 in March 2015 to T\$2.23/\$1 at the end of March 2016. If the weakening of the exchange rate continues, it will increase cost of imports and put upward pressure on inflation. The depreciation in Pa'anga against the US dollar moreover benefits the recipients of remittances in Tonga; is the opposite in the case though for recipients of New Zealand and Australian dollars.

Figure 23: Exchange Rate (period average)



Sources: National Reserve Bank of Tonga

RISKS

As noted earlier, the outlook for the medium term is positive and strong. However, there are still significant uncertainties and potential risks that could affect our projections. In the near term, the forecast for primary sector is highly vulnerable to weather conditions including rainfalls, drought, El Nino and other natural hazards that pose some risks to the agriculture sector as the case was in 2014/15. Furthermore, uncertainty around the timing of major construction projects would have a direct impact on our forecast for the construction sector. Weaker growth rate for the Secondary sector may be experienced in the medium term due to delays in the commencement of projects. If projects are scaled back or cancelled, these could also lead to weaker growth throughout the forecast period.

The high dependence of Tonga on economic conditions of major trading partners' (Australia, New Zealand and the United States of America) may affect remittances and demand for export if and when downturns are experienced in these countries. Lower remittances would also affect disposable incomes; domestic spending on goods and services will be subdued and tourist arrival may decline. All these will lead to a slowdown in domestic activity and slower overall GDP growth.

For a small economy like Tonga, the risk of greater reliance on global economy that is regularly plagued by wide fluctuations in commodities' prices is becoming more salient. Global prices of oil and food in particular are assumed will gradually increase towards the end of 2015/16. However sharp increase in commodity prices would be a major risk for the Tongan economy and may result in significant spike in costs of production, raise inflationary pressure and reduce household real incomes.

Strong accommodative and growth enhancing fiscal and monetary policies, effective implementation of programmes, 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, it is important to sustain the level of budget support from development partners as to drive achievements of set targets for the economic and social sectors. Current government efforts aimed at supporting SMEs and diversifying the export basket and trading partners will also be important for improved future growth prospects.