



# QUARTERLY ECONOMIC UPDATE (QEU) March 2017

(May 2017)

**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 2016/17 – 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) Fiscal data used in this QEU are still provisional and subject to change.
- d) The methodology for calculation of months for import cover has changed in February 2017 to include both imports of goods & services, as previous method use imports of goods only. The revision has back dated to September 2015.
- e) The following notations are used:
- nil
  - na not applicable (unless otherwise specified)
  - \$ refers to Tongan Pa'anga (TOP) (unless otherwise specified)
  - \$m millions of Pa'anga (TOP) (unless otherwise specified)
  - (e) estimates (unless otherwise specified)
  - (r) revised estimates (unless otherwise specified)
  - (p) projected (unless otherwise specified)
- f) The following acronyms referred to as:
- |         |   |
|---------|---|
| ADB     | Asian Development Bank                          |
| AUD     | Australian Dollars                              |
| BOP     | Balance of Payment                              |
| CT      | Consumption Tax                                 |
| EMDE    | Emerging Markets and Developing Economies       |
| GDP     | Gross Domestic Product                          |
| EU      | European Union                                  |
| IMF     | International Monetary Fund                     |
| MT      | Metric Tonnes                                   |
| MTO     | Money Transfer Operators                        |
| NPL     | Non-Performing Loans                            |
| NRBT    | National Reserve Bank of Tonga                  |
| NZD     | New Zealand Dollars                             |
| OET     | Overseas Exchange Transactions                  |
| PAYE    | Pay As You Earn                                 |
| TASP    | Tonga Agriculture Sector Plan                   |
| TSDF II | Tonga Strategic Development Framework 2015-2025 |
| UK      | United Kingdom                                  |
| USA     | United States of America                        |
| USD     | United States' Dollars                          |
| WEO     | World Economic Outlook                          |

## Table of Contents

<b>OVERVIEW .....</b>	<b>4</b>
<i>REAL SECTOR.....</i>	<i>6</i>
<i>FISCAL SECTOR .....</i>	<i>8</i>
<i>EXTERNAL SECTOR .....</i>	<i>9</i>
<i>MONETARY AND FINANCIAL SECTOR .....</i>	<i>9</i>
<b>RISKS.....</b>	<b>11</b>
<b>POLICY ISSUES .....</b>	<b>11</b>

### **List of Figures**

Figure 1: Agricultural Domestic productions (mt), quarterly .....	6
Figure 2: Agricultural Exports (mt), quarterly .....	6
Figure 3: Value and volume of Fisheries Exports, quarterly .....	6
Figure 4: Housing Loans & housing lending rate .....	7
Figure 5: Private Residential and Non-Residential Building Construction, Value & Number of Permits .....	7
Figure 6: Public Expenditure by Main Categories .....	8
Figure 7: Domestic revenue and Grants (T\$m) .....	8
Figure 8: Gross Foreign Reserves vs. Imports Cover .....	9
Figure 9: Annual Inflation Rate (%) .....	10
Figure 10: Domestic Fuel Prices (end of period) .....	10
Figure 11: Interest Rate .....	10
Figure 12: Exchange Rate (period average) .....	11

## OVERVIEW

Global growth is projected at 3.1 percent in 2016 by the IMF in the April 2017 World Economic Outlook update. Driven by continuing positive growth projections for the emerging markets and developing economies (EMDEs), global growth is expected to strengthen to 3.5 percent in 2017 and 3.6 percent in 2018. Similarly, a positive and increasing growth is projected for the Pacific island economies by the ADB in the December 2016 Pacific Economic Monitor update. In addition, the IMF projected a modest growth for Tonga's main trading partners—Australia, New Zealand and the United States—for the period 2016/17 to 2019/20. Nevertheless, given the tight linkages between Tonga and these economies, a protracted period of slower growth could weigh down through aid and remittances to Tonga and could lower demand for Tonga's exports.

At around 3 percent in 2015/16, Tonga's economy maintained the growth momentum of 2014/15. Growth projection for 2016/17 is at a rather subdued rate of 2.7 percent due to after events-shock as demand return to more normal level. The outlook for the medium term is positive, supported by continued recovery in agriculture, a more vibrant banking sector supported by growth-enhancing monetary policies of the NRBT, increasing trend of remittances from seasonal workers and increased foreign aid, boost in construction sector and attendant impacts on other subsectors, sound fiscal policies and development finance support to small scale industries. However, there are risks associated with medium term growth projections. Tonga's vulnerability to weather conditions and climate change is one of such risks. Others include the uncertainty that usually surround construction projects—a scale down in the size, delay or cancellation of major construction projects could lead to a weaker growth over the forecast period. In addition, weaker than expected economic conditions in Tonga's main trading partners may pose a risk to Tonga's economy through lower remittances, tourist arrivals and travel receipts and tapered demand for exports. Furthermore, sharp increases in global commodity prices in the near term could impact severely on Tonga's economy by way of increasing cost of production, higher inflation and reduction in household disposable income. Unchecked acceleration in credit growth could also post a risk to stability of the financial sector despite the decreasing non-performing loan (NPL).

The average annual inflation rate for the year ended March 2017 was 7.9 percent, higher than both the average of 6.5 percent in the December 2016 quarter and a deflation of 0.1 percent in March 2016. The growing inflationary pressure is associated with prices change in the global market, domestic policy changes and supply constraints in the domestic market. The flow-on effect of increases in the global oil market in recent times are reflected in increases in domestic fuel prices as well as electricity tariff. Increases in food prices in the global market and impacts of the initiatives to reduce consumption of unhealthy food through imposition of new customs and excise taxes that became effective in September 2016 led to rising domestic food prices and prices of other goods in the domestic market since late 2016. Furthermore, continuing shortages in the supply of kava adds to the domestic inflationary pressure. For the rest of the forecast period, inflation is expected to remain moderately above the reference rate of 5 percent set by NRBT.

From government revenue and expenses, provisional data indicates a surplus of \$7 million at the end of March quarter 2017 reflecting a sound fiscal control on government spending. Despite the lower collection of revenue and no budget support receipts during the review quarter it was sufficient enough to cater for the total expenditure for the concerned period. The decrease in both the total revenue and grants and total expenditure were expected due to lower economic activities held during the concerned period compared to previous quarter. Outlook for the next quarter will be higher due to more events fall in during the quarter and efforts to be made before end of the financial.

The level of foreign reserves at the end of March 2017 was \$366.0 million; equivalent to 6.8 months of import cover. The decline in foreign reserves during the quarter could be attributed to lower receipts of remittances and foreign aid for various projects—level of foreign reserves was \$378.8 million in the preceding quarter. Despite the decrease to 6.8 months of import coverage from average of 9 months for the past five years, the months (6.8) of import cover recorded for Mar 2017 quarter 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. The methodology used for calculation of the months of import cover have been revised in February 2017 and back dated to September 2015. The revision made to include both imports of goods & services (previous method use imports of goods only).

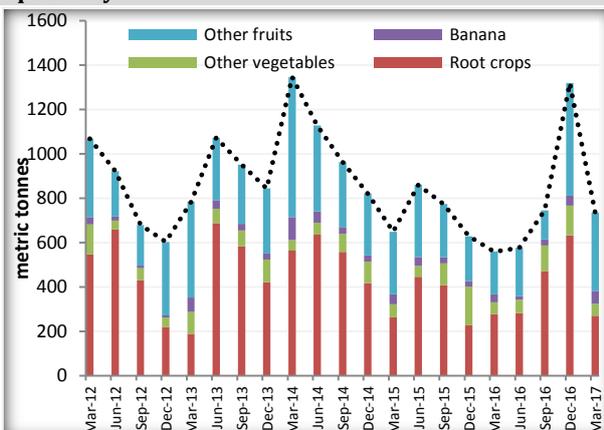
## REAL SECTOR

Subdued activities were recorded in the primary sector for March 2017 quarter compared to the previous quarter; it however performed better than same quarter in 2016 by 31.5 percent. The dip in quarterly performance was mainly a result of around 44 percent decline in domestic agricultural production—reduced output of root crops (mainly cassava and taro tarua), vegetables and other fruits. On the other hand, uptick in annual trend was driven by increase in the production of fruits, banana and vegetables.

In the same light, a 79.8 percent decrease in the total volume of agricultural exports was recorded for the reviewed quarter; an indication of the end of squash pumpkin season. In addition, there were decreases in the export of vegetables and fruits (mainly water melons, both brown and green coconuts), root crops (mainly cassava, giant taro, taro tarua and sweet potatoes), other products (kava powder and handicrafts) and leaves (taro tarua leaves). However, the increase in export by 30.6 percent on annual basis was supported by an increase in the volume of root crops (mainly from cassava, taro tarua, swamp taro, yam and giant taro) and leaves (taro tarua and frozen cooked pele leaves) exported.

Positive but moderate growth is projected for the agricultural subsector in 2016/17 through to the end of the forecast period, supported by expected positive outturn of various agricultural products as a result of ongoing government initiatives and good weather conditions.

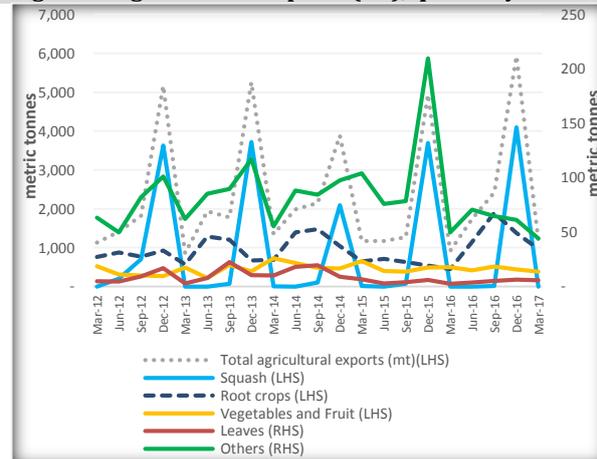
**Figure 1: Agricultural Domestic productions (mt), quarterly**



Source: Ministry of Agriculture, Food, Forestry and Fisheries

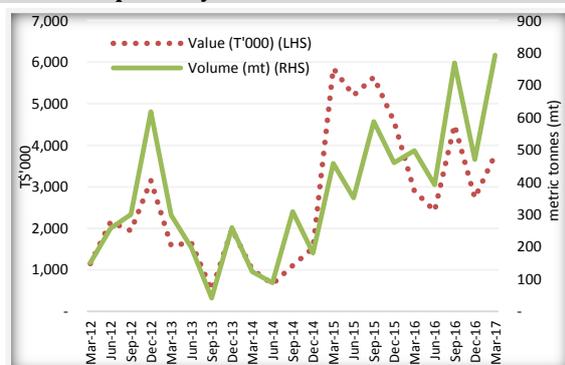
there were decreases in the export of vegetables and

**Figure 2: Agricultural Exports (mt), quarterly**



Source: Talamahu Market Qtrly Report, MAFF

**Figure 3: Value and volume of Fisheries Exports, quarterly**



Source: Ministry of Fisheries

percent respectively at the end of the review quarter compared to what was recorded in the corresponding period in 2016. The increases in annual trend are attributed to uptick in export of tuna, snapper, shark meat and live hard coral (aquarium product). Provisional data for March 2017 quarter

The fisheries subsector is estimated to continue at its positive but moderate trend throughout the forecast period. This is supported by increased volume and value of fisheries exports recorded at the end of March 2017 quarter compared to both the previous quarter and same period in 2016. Provisional data indicates a significant increase by 69 percent in the volume (metric tonnes) and 38 percent in value of fisheries products' exports—tuna and shark meat—in the review quarter compared to December 2016 quarter. On an annual basis, the volume of, and proceeds from fisheries exported were also higher by 59.3 percent and 29.9

also indicates a 90 percent increase in both the total volume and value of fisheries exports mainly of tuna followed by snapper and shark meat.

Ongoing activities under the Forestry subsector include re-planting of sandalwood, coconut trees and others forestry products. In addition, a number of initiatives are highlighted in the TASP 2016-2020 that would spur performance of the subsector through increased production of firewood, timber as well as production of electricity poles for both the export and domestic markets.

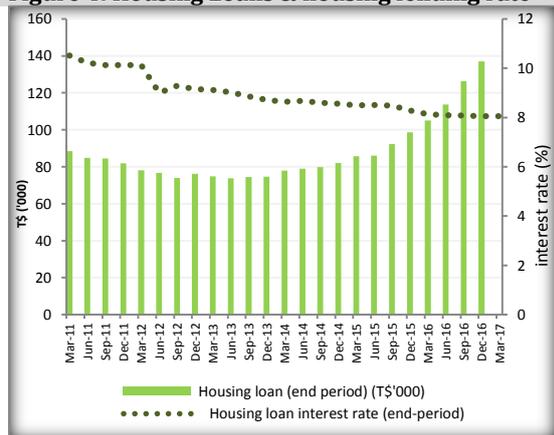
Positive outlook is anticipated for the primary sector in the medium-term. This will be supported by various initiatives being undertaken in each of the sub-sector as well as upgrading of rural and agricultural roads.

Robust activities continue in the secondary sector given the high number of ongoing construction activities—both public and private—during the review quarter. Some of these are the construction of St. George building complex, Fua Wharf, Ha’apai Reconstruction project, reconstruction of the Chinese Embassy building, Tonga Village Network Upgrading Project, phase 2 of the Aviation projects for upgrading of Fua’amotu and Lupepau’u runways. In the near term, more construction activities are planned: extension of fiber optic cable line to Vava’u and Ha’apai islands, extension of the solar farm project to the outer islands and Phase 2 of Tonga High School project and others.

Outlook for other subsector is assumed to move in the same direction as the positive outlook for the construction sub-sector. This is in view of the interrelationships between construction activities and other subsectors of the economy. The demand for inputs from these subsectors, such as quarries and sand from the Mining & Quarrying subsector, blocks from Manufacturing subsector, and water and electricity from the Electricity and Water supply subsector, go up as construction activities expand.

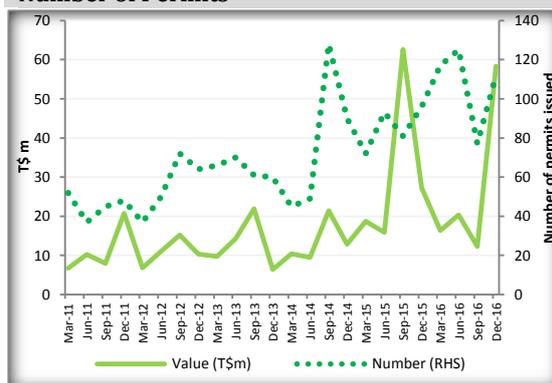
The positive outlook for the construction subsector is also associated with favorable and decreasing interest rate on housing loans (*refer* Figure 4) and the increasing trend in the value and number of building permits issued (*refer* Figure 5).

**Figure 4: Housing Loans & housing lending rate**



Source: National Reserve Bank of Tonga

**Figure 5: Private Residential and Non-Residential Building Construction, Value & Number of Permits**



Source: Ministry of Infrastructure & Tourism

Economic activities in the tertiary sector over the review quarter were slower compared to the previous festive quarter, though higher than the same period in 2016. This is associated with the decline in the wholesale and retail trade subsector, decrease in remittances, observed decrease in the advertisement of vacant posts and lower tourist arrivals. However, the annual total for travel receipts recorded at the end of March 2017 was higher compared to previous quarter and same period in 2016. The increase in travel receipts is in line with the opening of the Tanoa Hotel during the review quarter. In addition, demand for domestic transport services increased—both sea and air—associated with the return to Tongatapu

of students, parents and workers who have spent their New Year holiday in the outer islands. At the same time, growth in household and business credit witnessed during the quarter is an indication of the potential for increase in economic activities in the tertiary sector.

## FISCAL SECTOR

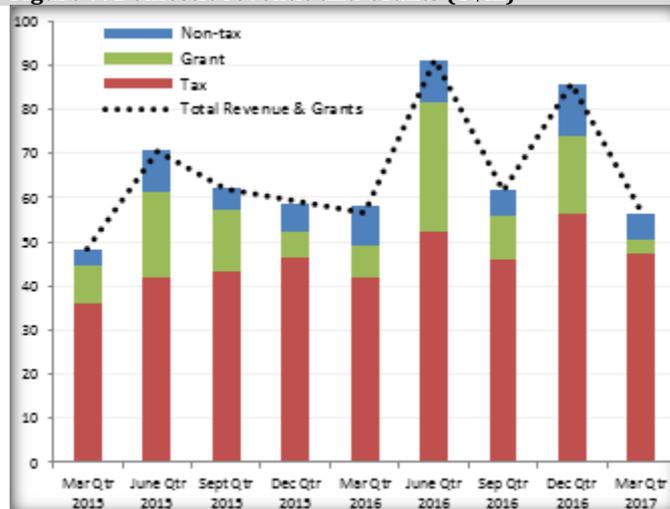
Overall, the provisional data for fiscal position at the end of March quarter 2017 was a surplus of \$7 million. This is a result of around \$57 million receipts from revenue and grants versus of about \$50 million for government spending (above the line) over the review quarter. Available data indicates that total revenue and grants decreased when compared to previous quarter, however, it remains higher than the government spending over the review quarter.

Total revenue and grants received during the quarter (Mar 2017) were around 34 percent lower than the previous quarter as a result of lower collection mainly from taxes on international trade and transactions, taxes on incomes, profits and capital gains, taxes on goods and services, property income, sales of goods and services and others. During the review quarter, no budget support has been received and cash grants receipts were down by 83 percent and 60 percent compared to previous quarter and corresponding period in 2016 respectively. On annual basis, total revenue and grants has increased slightly by 0.2 percent from the same period in 2016 mainly attributed to the increase in collection from tax items. Domestic revenue collection at the end of March quarter 2017 contributes around 22 percent to the revised estimates for 2016/17.

On the expenditure side, provisional data indicates that government expenditure for the March quarter 2017 was around 32 percent and 15 percent lower than the previous quarter and the corresponding period a year ago respectively.

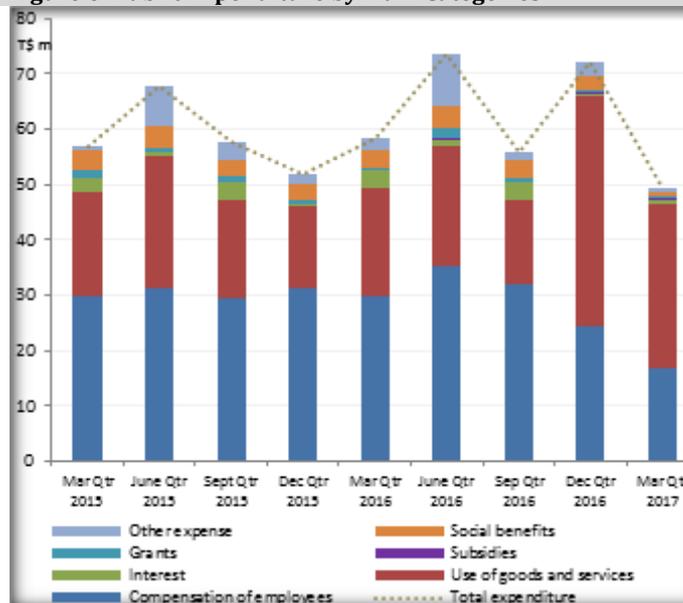
The decrease in the quarterly trend was mainly due to lower payments on compensation of employees (by 31 percent), uses of goods and services (by around 28 percent), social benefits (by around 78 percent), grants (by around 14 percent) and other expenses (by 61 percent). On annual basis, factors for the 15 percent decrease were lower payments on interest (by 80 percent), social benefits (by around 82 percent), compensation of employees (by around 44 percent) and other expenses (by around 59 percent). The total expense for March quarter 2017 contributes 15.4 percent to the revised budget estimates for 2016/17.

**Figure 7: Domestic revenue and Grants (T\$m)**



Source: Ministry of Finance and National Planning

**Figure 6: Public Expenditure by Main Categories**



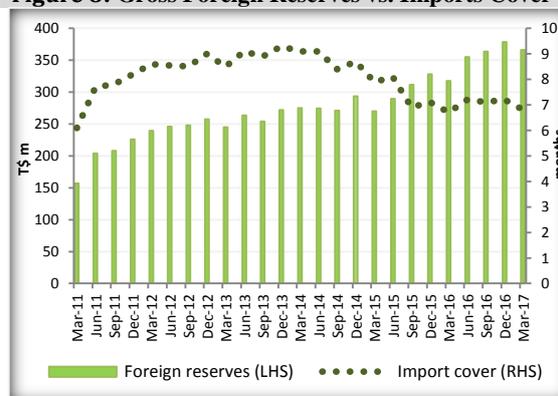
Source: Ministry of Finance and National Planning

## EXTERNAL SECTOR

The expected earnings from export at the end of March quarter 2017 were lower than the previous quarter earnings; however higher than the same period in 2016—indicating recovery (year-on-year basis) in the agricultural sector from the drought effects in 2014/15. The decrease in the overall exports recorded for the review quarter was mainly due to the decrease in agricultural exports despite the increase in fisheries export. The decrease (on quarterly trend) in agricultural exports was due to seasonality of squash pumpkin as well as the decrease in other non-squash items including leaves, root crops, vegetables and fruits and others. On an annual trend, positive performance of overall exports was consistent with increase in the proceeds from fisheries products recorded for March 2017 quarter compared to the corresponding period in 2016. This was due mainly to the increase in export values of tuna and shark meat. The Overseas Exchange Transactions recorded a lower (by 40 percent) exports compared to the previous quarter; however higher (by 36 percent) than the same period in 2016. This moves in the same direction as remittances and other official transfers. The outlook is that Overseas Exchange Transactions Trade balance account for the next quarter will remain in deficit due to more import payments, despite anticipated higher transfer balance. The push factors in the projected increase in remittances and other official transfers for the next quarter include preparation for the annual church conferences, schools and ex-students anniversary celebrations, the Heilala festivities as well as many family reunions and other functions. Import payments at the end of March quarter 2017 were lower than the previous quarter but higher than the same period in 2016. The increase in year-on-year basis is in line with continuing increase in global commodity prices. Demand for goods and services is anticipated to increase in the next quarter due to preparation for above mentioned events. The positive prospects for agricultural and fisheries exports as well as in the exports of squash pumpkin will mitigate potential deficits in the current account of the BOP in the near term.

Foreign reserves recorded at the end of March 2017 was \$366.0 million, 3 percent or \$12.8 million lower compared to the previous quarter. This level was however 15 percent or \$48.7 million higher compared to same period in 2016. Lower remittances and foreign aid receipts during the review quarter accounted for the quarterly decline. The increase on annual basis was due to higher receipts of foreign aid and budget support. The level of foreign reserves recorded for March 2017 quarter was equivalent to 6.8 months of import cover; well above the minimum range of 3-4 months set by NRBT.

**Figure 8: Gross Foreign Reserves vs. Imports Cover**



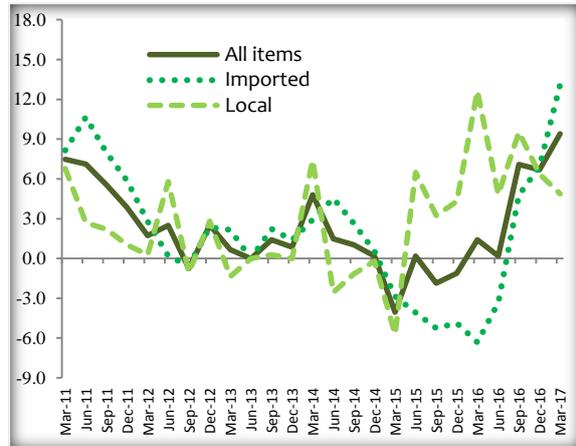
Source: NRBT

## MONETARY AND FINANCIAL SECTOR

The annual inflation rate at the end of the March 2017 was 9.4 percent compared to 6.7 percent recorded (year-on-year) at the end of the previous quarter and 1.4 percent at the end of March 2016. The significant year-on-year increase in the period ended December 2016 was mainly driven by the imported component at an annual inflation rate of 13.1 percent; the local component was only 4.9 percent. On year-on-year comparison, increase in the March 2017 inflation was driven by higher prices for local component with an annual inflation rate of 12.6 percent. On an annual basis, continued increase in the Tobacco, alcohol and Kava component led the pack with an annual inflation rate of 27.9, followed by the Transportation component (17.7 percent) and Food component (10.2 percent). Shortages and increasing price of Kava Tonga—which drives the increase in price of local items—and rising prices of tobacco and alcohol since July 2016 (as a result of new customs and excise tax aimed to promote healthy lifestyles) remain as driving factors. With the same purpose of promoting healthy life style, the increase

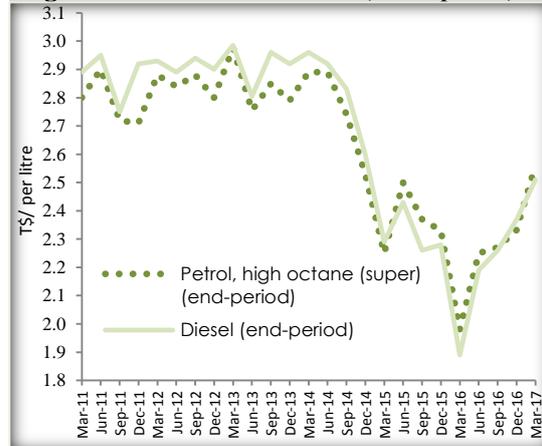
in prices of imported food items—meat and poultry—are ascribed to the new customs and excise tax. Depreciation of the Pa’anga against the USD, NZ and Australian dollars also contributed to the increase in price of imported components of the CPI. Furthermore, recovery in oil prices in the global market is reflected in the increase in prices of fuel in the domestic market.

**Figure 9: Annual Inflation Rate (%)**



Source: Tonga Statistics Department

**Figure 10: Domestic Fuel Prices (end of period)**

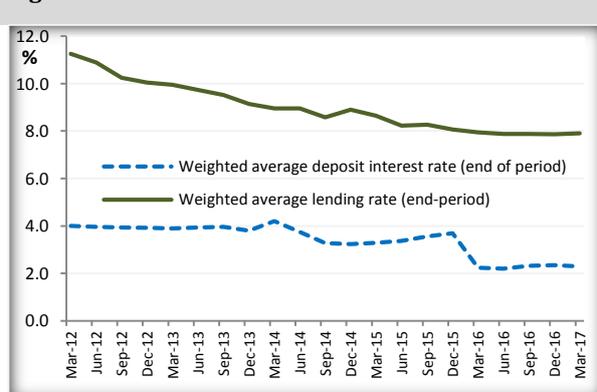


Source: Competent Authority, Ministry of Labor, Commerce and Consumers

Domestic prices for petrol and diesel at the end of March quarter 2017 increased, compared to previous quarter and corresponding period in 2016. This is in line with the upward movement in global oil price index including the Singapore refined petrol prices on year-on-year basis. Other contributing factor to the increase in the domestic prices of fuel include the depreciation of the pa’anga and higher cost of freight services.

The outlook for inflation in the medium-term is that it will remain higher than the inflation reference rate of 5 percent set by NRBT. Changes in global market conditions would be transmitted to the domestic market and impact on our projected outlook for the medium term. The need to promote healthy lifestyles and reduce the negative consequences of NCDs necessitated the review of customs and excise taxes (effective in July 2016) to reduce the consumption of imported fat meat and unhealthy food items. The increase in prices associated with this also coincided with the recovery in the external conditions—rising global commodity prices.

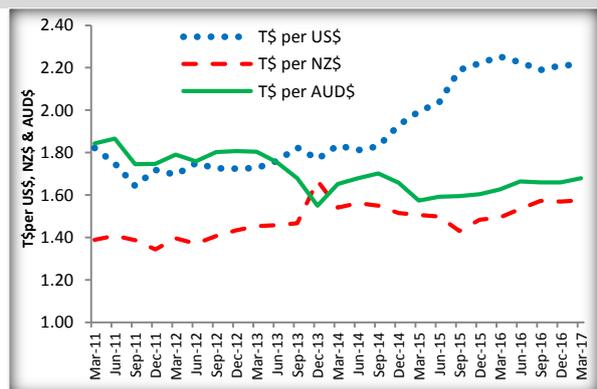
**Figure 11: Interest Rate**



Sources: OET, NRBT

Weighted average deposits interest rate at the end of March 2017 quarter increased when compared to December 2016 quarter and same quarter in 2016. Similarly, on quarterly basis, weighted average lending interest rate increased but remained lower than it was the same period a year ago. Both interest rates for housing and business loans were lower when compared to corresponding period in 2016. The higher deposit rates and cheaper lending rates continue to encourage economic activities and promote economic growth.

**Figure 12: Exchange Rate (period average)**



Sources: OET, NRBT

Over the March 2017 quarter, on period average, value of Tongan Pa'anga weakened against the US, Australian and New Zealand dollars compared to previous quarter. If the weakening of the exchange rate continues, cost of imports will be on the rise and cause upward pressure on inflation. On the other hand, depreciation in the Pa'anga benefits the recipients of remittances in Tonga and increase demand for goods and services and imports.

## RISKS

The outlook for the Tongan economy in the medium term remains positive; however, there are potential risks that may affect our projections. These risks include the high vulnerability of our forecast for the Primary sector to weather conditions. In addition, scale down and delays in the commencement of major construction projects could lead to a weaker growth in the construction sub-sector and dampen our growth projections in the near term.

Development in the global market and in the economies of our main trading partners will definitely impact Tonga's economic activities and overall GDP growth. This is due to Tonga's high dependence on these economies; a slow-down in any of them would result in lower remittances, household disposable income and demand for Tonga's exports.

## POLICY ISSUES

From global perspectives, the IMF continues to remind that situations in many advanced economies could further dampen global growth. These include the spill-over effects of the United Kingdom's exit from the European Union, tighter credit conditions, exchange rate fluctuations, and the recovery of prices in global commodity markets. In the near-term, outlook for Asia remains strong; the need remains though for accommodative policies amidst recent easing of financial conditions that underpin domestic demand so as not to trigger weak export growth.

In these regards, accommodative and growth enhancing fiscal and monetary policies, timely and efficient 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 Tonga.

The need to sustain the level of budget support from development partners and achieve desired growth trajectories for sustainable economic and social development implies that collective efforts from government and stakeholders in the economy must continue to comply with set conditions. Simultaneously, government must not waiver in its efforts to support SMEs and diversify the export basket and trading partners, enhance business-enabling structural reforms and improve efficiency of the public sector. Strict implementation of the performance management system for public sector and its recruitment policy are also key in government efforts to improve total capital productivity.

Furthermore, sustainable fiscal sustainability in the country implies strict adherence to established fiscal anchors. That is, maintain at a lower level the government spending on wage bill which poses a threat

to budget balances and could lead to higher public debt. In addition, continuing implementation of 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. Macro-prudential tools to better manage liquidity and credit cycle will also 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 low levels of employment, hardship and poverty.