



QUARTERLY

ECONOMIC

UPDATE (September Quarter 2015)

(November 2015)

**NATIONAL PLANNING & ECONOMIC DEVELOPMENT DIVISION
MINISTRY OF FINANCE & 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
 - 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., FY2014 ends on 30 June 2014
 - Forecast period refers to 2014/15 – 2017/18.
- 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)
 - mt metric tonnes
 - \$ refers to Tongan Pa'anga (TOP) (unless otherwise specified)
 - \$m millions of Pa'anga (TOP)s (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:
- | | |
|----------------|---|
| NRBT | National Reserve Bank of Tonga |
| OET | Overseas Exchange Transactions |
| TSDf 2015-2025 | Tonga Strategic Development Framework 2015-2025 |

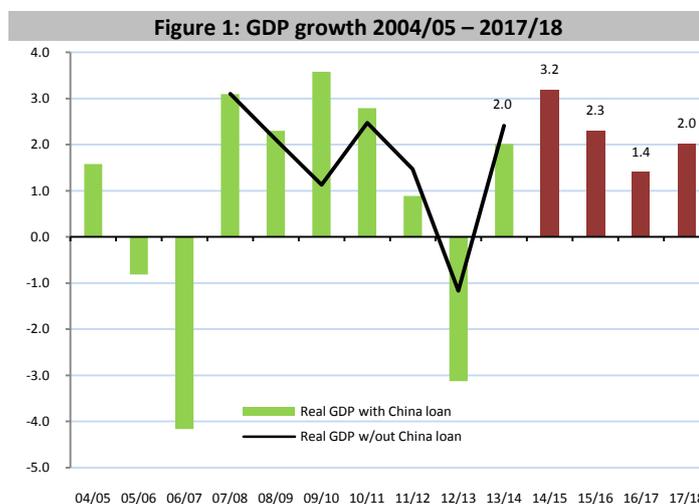
Table of Contents

OVERVIEW	4
REAL SECTOR	6
<i>PRIMARY</i>	6
<i>SECONDARY</i>	7
<i>TERTIARY</i>	9
<i>RISKS</i>	11
FISCAL SECTOR	13
EXTERNAL SECTOR	14
MONETARY AND FINANCIAL SECTOR	14

OVERVIEW

This Quarterly Economic Update (QEU), September 2015, discusses recent economic developments using the latest data available since the June 2015 QEU and provides an interim update of the economic outlook relative to our July GDP forecasts.

In July, we forecast real GDP growth to strengthen in 2014/15 then soften to 2016/17, before returning to average growth by 2017/18. Strong growth in 2014/15 and 2015/16 is due largely to donor-funded construction projects and increased activity around the Coronation in July 2015 and related to the Tupou College 150th Anniversary in 2016. The primary sector is expected to continue recovering from drought and return to positive growth in 2015/16. Weaker growth in 2016/17 is due to a fall in activity back to around more normal levels after the effects of the Coronation and Anniversary events. Growth through this period remains supported by continuing public and private sector construction projects including the St. George Building, Tanoa Hotel and preparations for the 2019 Pacific Games.



key:
actual from SD
MOFNP projections (forecast period)

Despite the strength in fisheries exports, the latest official agricultural export data (March quarter 2015) shows signs that growth in the primary sector has slowed due to the effects of drought on agricultural production in 2014/15. Hence, growth anticipated for the primary sector for the year 2014/15 remains weak and expects a gradual increase in 2015/16 and rest of the forecast period.

Construction activity continues to dominate GDP growth for the secondary sector through our forecast. Growth in Electricity and Water Supply could be stronger than previously forecast and growth in the Manufacturing industries is generally forecast to continue to grow at its historical average growth. One of the big donor-funded construction projects started during the review quarter, St. George building complex. Hence, GDP growth for the secondary sector is expected to strengthen through to the end of the forecast period supported by strong construction donor-funded projects that are currently undertaking as well as the construction activities in preparation for the 2019 Pacific Games.

Growth in the tertiary sector continues to be driven by three main factors. These are: two one-off events (the Coronation in June 2015 and the Tupou College 150th Anniversary that will happen in June 2016); improvements in the Tourism industry due to the improving outlook for activity in trading partner economies through to the forecast period; and changes in public

sector recruitment policy which will may lead to lower growth in public administration services.

Fiscal data indicated that both domestic revenue and cash grants decreased at the end of September quarter 2015 compared to the previous quarter and corresponding period last year. The decrease reflected less Coronation effects through lower imports duty. Domestic revenue collected at the end of September 2015 is 22 percent of the original budget estimated for 2015/16. The decrease in cash grants was due to more budget support received in the previous quarter compared to the review quarter and same period last year. However, that is related to the donors' timing for releasing of fund and when the related works required are ready.

Public Expenditure made at the end of September quarter 2015 was lowered compared to June quarter, but higher compared to same period in 2014. The quarter-on-quarter decrease is in part due to seasonality as payments tend to be weaker in September than in June quarter. In addition, the June quarter payments were higher than normal due to Coronation effects, meaning lower payments in September is to be expected. Lower payments were mainly featured in the decrease in payments for the compensation of employees, use of goods and services and interest payment overseas.

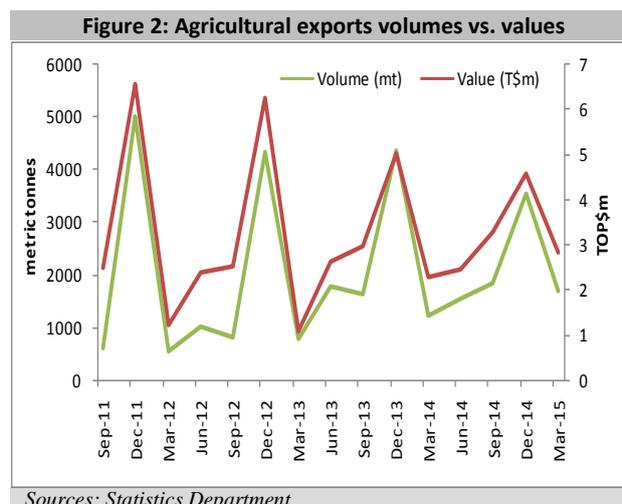
At the end of September 2015, foreign reserves were \$311.7 million pa'anga, the highest over history, which equivalent to 8.8 months of import cover. This is well above the minimum range of 3-4 months of import cover set by the National Reserve Bank of Tonga. The NRBT expects foreign reserves to remain well above the minimum range, assuming that both remittances and travel receipts continue to increase.

In its World Economic Outlook – October 2015, the IMF revised down its projection for global growth for 2015 to 3.1 percent from the 3.3 percent than was previously forecasted in July 2015 while its projection for future years remains unchanged. Growth in the advanced economies is forecast to pick up slightly towards the end of 2015 while growth in the emerging market and developing economies is forecasted to slow over this same period, reflecting weaker outlooks in China and the oil-exporting countries. With declining commodity prices, reduced capital flows to emerging markets and pressure on their currencies, and increasing financial market volatility, downside risks to the outlook have risen, particularly for emerging market and developing economies. The IMF forecasts growth in Tonga's main trading partners (Australia, New Zealand and the United States) to increase gradually through to the end of their forecast period. This improving outlook should support remittances back to Tonga and demand for Tonga's exports. However, the anti money laundering may have an impact on the remittances.

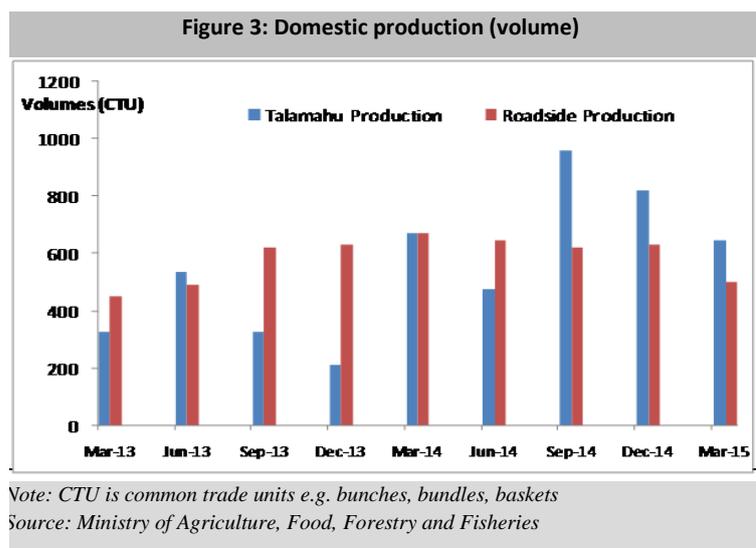
REAL SECTOR

PRIMARY

Agricultural exports fell in the March quarter 2015 compared to December quarter 2014. However, this is largely due to a seasonal fall reflecting the offseason for squash pumpkins and also drought effects for other products. The decline is reflected across most products other than squash pumpkin. However, it seems there has been some recovered in production in March quarter 2015 compared to the corresponding period in 2014. Values of agricultural exported products moved similarly to agricultural exported productions. Overall, *Figure 2* illustrates a slow recovery in the industry in March 2015 level compared to other previous March quarters.



Total agricultural production for domestic consumption has been declining over each of the three quarters to March 2015. The main reason for the decrease is due to the effects of drought. Sales have decreased for both Talamahu market and roadside markets. The decline in domestic market sales is evident across most products. Most notably, root crops were lowered in March quarter 2015 compared to previous quarter and slightly



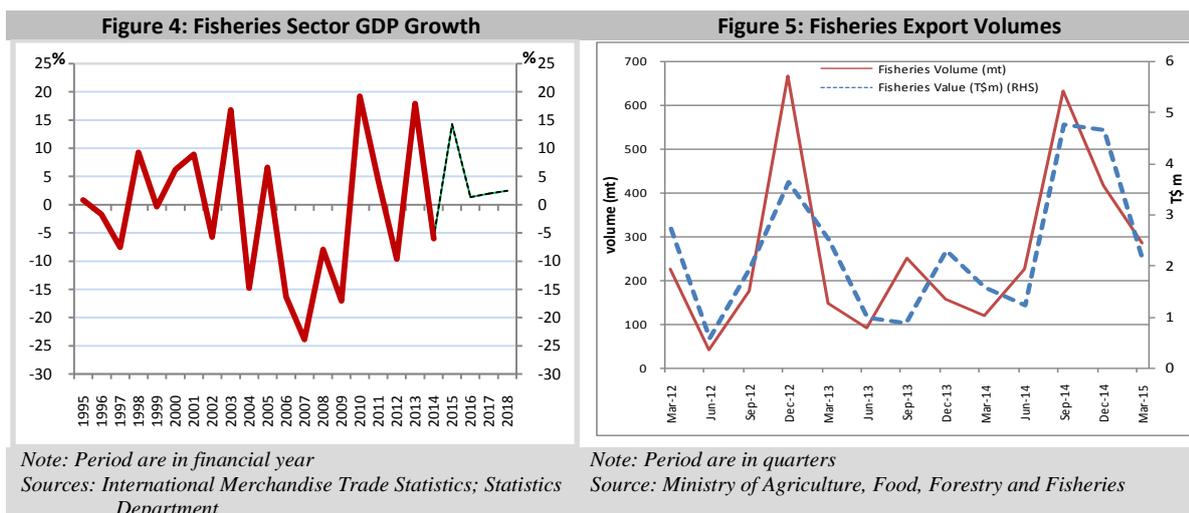
lowered than the corresponding period in 2014. The volume for most of other agricultural commodities sold in these two markets follow the same trend as root crops.

We still forecast positive growth for the primary sector for 2015/16 onwards (as reported in our June 2015 Quarterly Update) as production normalizes following the effects of the drought. However, Tonga is facing another El Nino weather pattern with the possibility of further drought conditions. Another drought would again reduce agricultural production and cause lower growth in the sector than we had forecast. During the review quarter, Department for Meteorological services released announcements to the public about the El Nino conditions and drought warnings stressing out preparedness and to wisely use of water resources in due courses. Growth for the industry is anticipated to be well supported by initiatives including more improvements in the market access and diversification of export products including butternut and butter-kin, vanilla and coconut. The positive outlook is also

supported by the re-opening of the European market for kava from September 2015, in which the activities has already taken place but yet to receive a provisional data for that. The improving of access to Agricultural Marketing Fund would help to support the level of GDP, although its contribution to growth would be relatively small.

Weak growth in the agriculture industry in 2014/15 is being partially offset by strength in the fisheries industry. Latest available export data indicates a higher level in both the value and volume of fisheries exports in the first three quarters of the 2014/15 year– significantly higher than the corresponding period in 2013/14. This increase was driven by a strong increase in tuna exports supported by the exports of snapper, seaweed and Bech-de-mer. Other on-going activities that would assist the high performance in good catches could be through enforcing of further reviewing and to revise of vessel licenses condition such as all fishing should be offloading here instead of fishing here then offload it somewhere else.

Positive, although a low, growth is anticipated for the fisheries industry for the rest of the forecast period. Performance of the sector is very volatile and difficult to predict. However we expect activity to be supported by various initiatives including increasing shipping capacity for export, supported by higher utilization of the Fisheries Development and Export Fund but investment on this sector is very low.



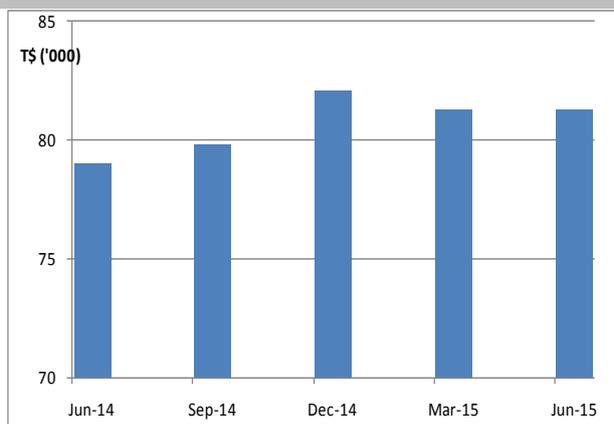
SECONDARY

Construction activity remains the main driver of growth for the secondary sector through our forecast. Growth in the manufacturing and electricity and water supply industries are generally forecast to continue to grow at around their historical average growth rates.

Construction activity appears to have strengthened over recent months. Public construction has increased with the commencement of the construction of the St. George Building Complex. Large volumes of other public (donor-funded) construction projects are also ongoing, including the Ha’apai reconstruction and utilities network upgrades. This strengthening in construction activity is consistent with the profile of projects included in our public construction forecast.

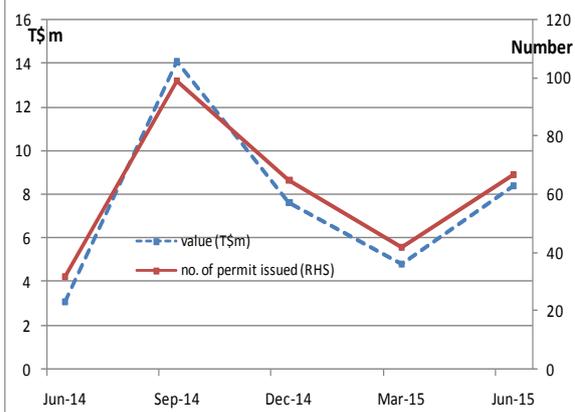
In July, we forecast private residential construction to increase based on the upward trend in housing loans observed through to the March 2015. Housing loans remains fairly flat in the June quarters 2015 while value and number of building permit increase compared to previous quarter and remains higher than the same period last year. Based on planned projects, supported by the continued strength in total imports of construction materials, the outlook for the industry is positive.

Figure 6: Housing Loans



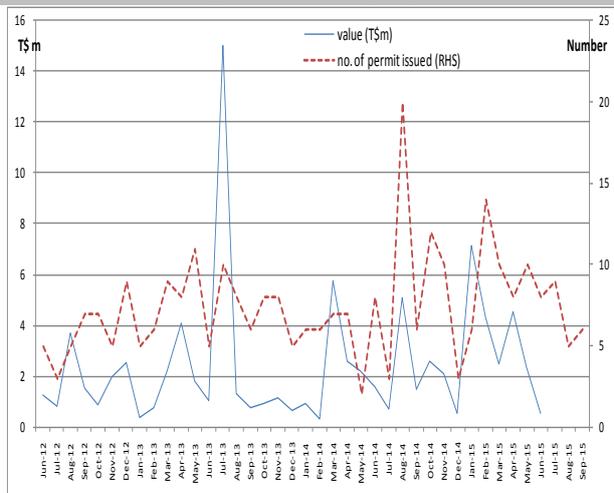
Source: National Reserve Bank of Tonga

Figure 7: Private Residential Construction by value and number of permit



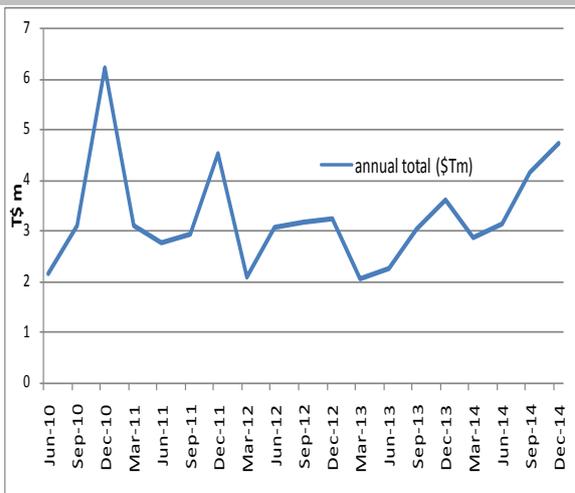
Source: Ministry of Infrastructure

Figure 8: Private Non-Residential Building Construction, Values and Number of Permit



Source: Ministry of Infrastructure

Figure 9: Total Imports (TOP millions)



Source: Statistics Department

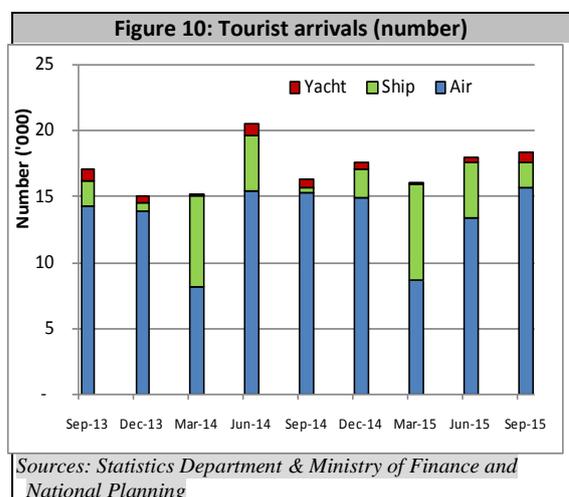
Both annual total electricity production and consumption at the end of June 2015 were higher compared to previous year. This was largely due to higher demand for these services to cater for Coronation event and ex-students celebrations in addition to on-going construction project activities. This is evident by the data that at the end of June 2015 the annual total electricity production and consumption were 1.6 percent and 2.8 percent, respectively, both higher than the previous year. This level of production is slightly stronger than we had forecast for the year and indicates GDP in the industry could be higher than we had anticipated for 2014/15.

The increase in production and consumption of electricity is due in part to lower global oil prices that have translated into lower local fuel and electricity prices. Lower prices are likely

to have increased the quantity of electricity demanded, as has continuing increases in electrical products. The strengthening in construction activity is also increasing the demand for electricity and water. The most recent months electricity production data indicated an increase in production and continued to be strong since June quarter.

Construction activity is expected to continue to strengthen through our forecast, due mainly to continuing work on existing donor funded construction projects and the commencement of new project –most notably the expansion of solar farm projects, the St George Building project and preparations for the 2019 Pacific Games. Growth is then anticipated to fall back to an average of 1.6 percent in the outer years if there are no bigger construction projects to hold up the level of construction. Strong construction activity will continue to support growth in the electricity and water supply industry and in mining and quarrying.

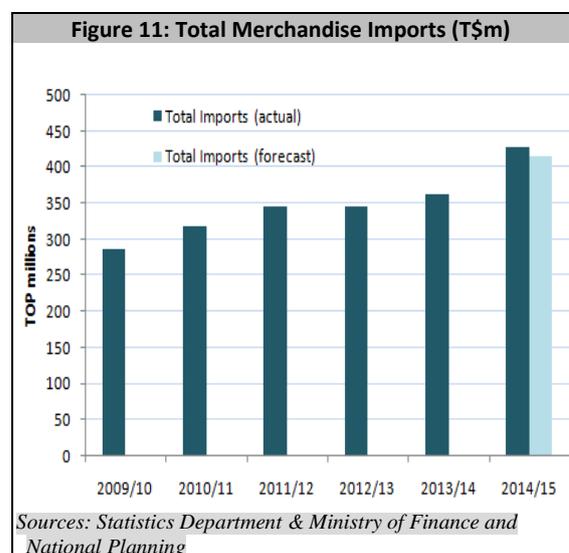
The positive outlook for manufacturing sector is also support by the increase in the number of tourists arrived in Tonga as well as an increase in the number of manufacturing businesses registered due to the higher demand for their services.



TERTIARY

Recent developments and the outlook for the tertiary sector continue to be driven by three main factors. First, two one-off events: the Coronation which happened in July, and the Tupou College 150th Anniversary, which will occur in June 2016. Second, tourism activity is expected to grow, supported by these events and an improving outlook for activity in trading partner economies. Third, developments in public sector recruitment policy will affect forecast growth in public administration services. Based on these factors, growth in the tertiary sector is expected to strengthen in 2014/15, moderate growth in 2015/16 and 2016/17 then return to around average growth at the end of the forecast period.

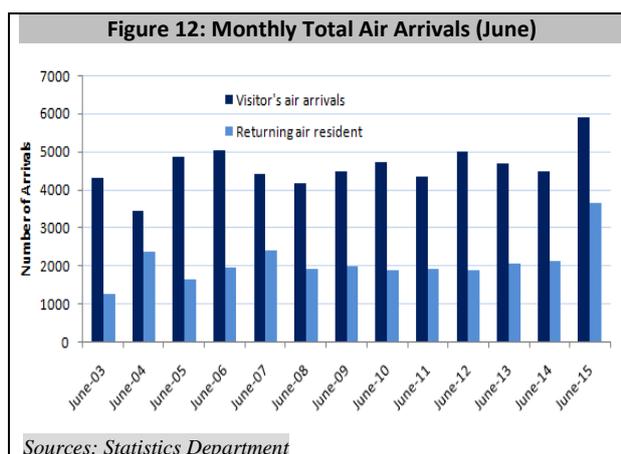
The Coronation and other ex-students celebrations generated strong demand for wholesale and retail goods through the end of 2014/15. This is evident in strong increases in the level of imports. The total value of imports in the year to June 2015 was T\$428.9 million, an annual increase of 18 percent compared to the previous year. This is the biggest annual increase since 2007/08 (the time of the last Coronation). By components, the largest increases in imports were evident in meat and

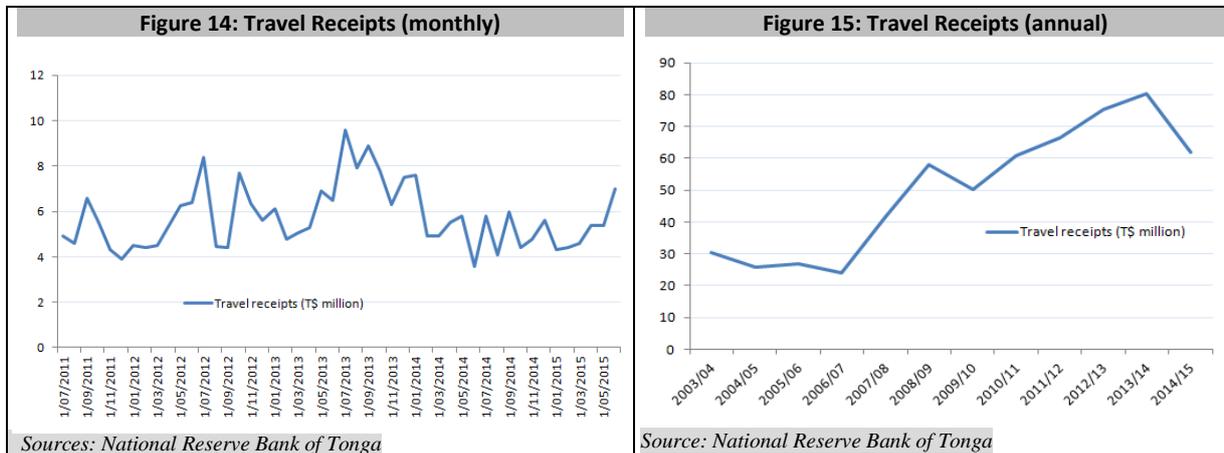


processed foodstuffs, textiles, machinery and appliances, and vehicles. Imports over the past couple of months remain flat, slightly lower than the average, T\$24 million, for the last twelve months. This indicated that the level of imports has fallen back to more normal after the events.

Although the level of monthly imports has fallen back in August since June 2015, this was expected as there were no events to maintain the high level of imports. However, we expect the imports to strengthen again later in 2015/16 as preparations and celebrations associated with the Tupou College 150th Anniversary again boost demand for imports and support activity in the wholesale and retail trade industry. This implies a similar level of activity but zero growth for the 2015/16 year in this industry. The level of demand for imports and activity in the wholesale and retail trade industry is expected to fall back to more normal levels after these two one-off events, causing the growth for the sector to drop, before recovering back to more average growth at the end of the forecast period.

These one-off events also impact on the hotels and restaurants industry. The Coronation created high demand for the hotel and restaurant services from a large increase in total air arrivals in June and July 2015. Total air arrivals in June and July 2015 were 32 percent and 9 percent higher than the same months in the previous year. The overall increase in arrivals was consistent with what we had forecast. However, the composition of arrivals indicated a higher than expected number of returning residents and a lower than expected number of visitors. This may indicate lower demand for hotel and restaurant services than we had forecast as returning residents are more likely to stay with family than at hotels. Consistent with the increase in arrivals, travel receipts also increased strongly in June and July. Travel receipts increased by 119 percent and 337 percent respectively over the same periods last year. Although it's only a 1 percent higher in the total arrivals for the year to June and July 2015 compared to the 23 percent increase in the same period last year, the 1 percent increase was from a higher number of arrivals in June, over 1,400 arrivals more than June 2014.





We expect the impact on demand for hotels and restaurants from the Tupou College Anniversary in 2016 to be lower than from the Coronation. While we expect a high number of arrivals, we assume that attendees will be mostly Tongans who may be more likely to stay with their relatives and friends, and by the nature of the celebrations are less likely to demand restaurant services. Because of this, we expect growth in the sector to be mildly negative in 2015/16. We then expect growth to strengthen again in later years as the completion of the Tano’a Hotel by 2016/17 draws new tourists to Tonga.

The Coronation is also likely to have boosted activity in the transport and communication industry. There was a significant increase in the number of flights per week to Tonga around the event. While the flights were not by Tongan operators, the provision of airport services will have provided a boost to GDP. Demand for land transport services was also likely to be higher through this period. The transport industry is also being supported by increases in construction activity, including the need to transport construction materials to Ha’apai for reconstruction projects.

The sector is also benefitting from the ongoing competition between the two domestic telecommunication operators, assisted by the fibre optic cable, resulted in increasing usage, cheaper prices, coverage and more promotions offered to their customers despite the small size of the market.

RISKS

Our assessment of the potential risks to the economic outlook remains similar to our last report. Our forecast for the primary sector remains highly vulnerable to weather conditions. We expect production in the agriculture industry to continue to recover following the effects of drought in 2014/15. However, the Tonga meteorology services have indicated that Tonga is facing another El Nino weather pattern, which increases the risk of drought, and may also increase cyclone risks. This is consistent with the South Oscillation Index of -0.4 for the March Quarter 2015 reflecting that the industry has been affected by the drought and by the conditions of El Nino. Another period of drought would again limit or further reduce production in the agriculture sector and reduce GDP growth below what is currently forecast for 2015/16.

Weaker growth for the Secondary sector could be experienced if there are significant delays to donor-funded public construction projects. While these delays would create weaker growth

in the near term, growth in subsequent years may be stronger. There remains significant uncertainty as to the funding and activity profile of construction of facilities for the 2019 Pacific Games. We assume only a small amount of activity in the current fiscal year with stronger activity in 2016/17 and 2017/18. We will continue to monitor developments in funding options and the scale of the planned constructions.

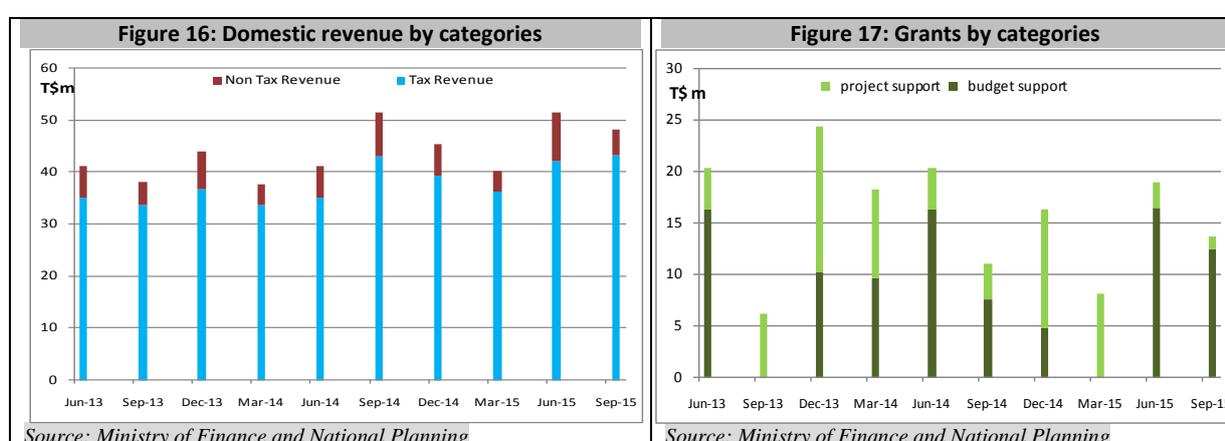
As a small economy, Tonga is heavily reliant on imported goods. At present the cost of imports is relatively low, due to falls in global commodity prices (including oil and food). The cost of imported goods would rise with increases in commodity prices and with depreciation of the pa'anga. The IMF expects commodity prices to remain relatively low for an extended period of time. However, the US dollar has been appreciating recently. If US dollar continues to appreciate it will cause higher cost for imports and contribute to a rise in the imported component of inflation, particularly through higher fuel and electricity prices.

Tonga is also highly dependent on the economic conditions of its main trading partners' (Australia, New Zealand and the United States of America). If these economies become weaker, it would have resulted in a slow down domestic activity and overall GDP. The IMF projects growth in the US at 2.6 percent for 2015 and 2.8 percent its projection for 2016. This is 0.1 percent point higher in 2015 and 0.2 percent points lower in 2016 than their July WEO Update 2015. Growth in Australia and New Zealand are also expected to continue to improve. Weaker growth in these economies would affect remittances and demands for exports.

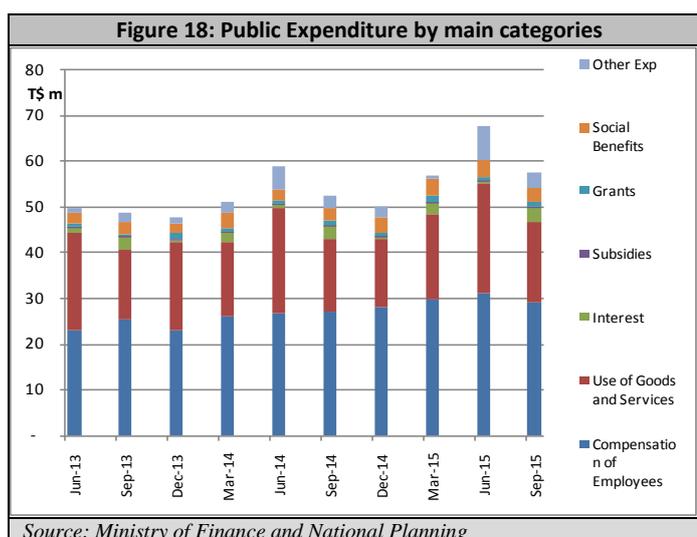
FISCAL SECTOR

In September quarter 2015, domestic revenue decreased by 6.6 percent compared to the previous quarter, and by 6.3 percent compared to the corresponding period in 2014. The quarterly decrease was mainly due to a large decrease in collections from non-tax items (down by 48.5 percent), particularly from property income and dividends from public enterprises. Dividends were normally due at the end of June every year, hence, the large quarterly differences. In addition, collections from corporate taxes both from small and large businesses were also lower than the previous quarter. Domestic revenue collected in the September quarter 2015 is 22 percent of the original budget estimated for 2015/16.

Cash grants were 24 percent lower in the September quarter compared to June quarter but more than three times higher than the September quarter a year ago. The low level of cash grants receipts in the September quarter was due to more budget support received in the previous quarter compared to the review quarter and same period last year.



Total government payments were also lower in the September quarter 2015, by 15 percent, than the previous quarter but 10 percent higher compared to the corresponding period last year. The quarterly decrease was in part seasonal, as the June quarter is typically the highest season of payments due to it being the last quarter of the financial year. The June quarter payments were also boosted by Coronation expenses, as a significant amount of this expense would have been incurred ahead of the Coronation. Payments in the review quarter amounted to 17 percent of the estimated total government payments for the year reported in the Budget Statement 2015/16. The lower payments in this September quarter were mainly due lower payments for purchases of goods and services and compensation of employees. However, payments were higher than in the previous year due to an increase in the number of employees, more purchases of goods and services due to Coronation and higher interest payments on external



debt. A lower level of government payments is anticipated in the December quarter (in line with previous years), as government departments will be closed for Christmas season.

EXTERNAL SECTOR

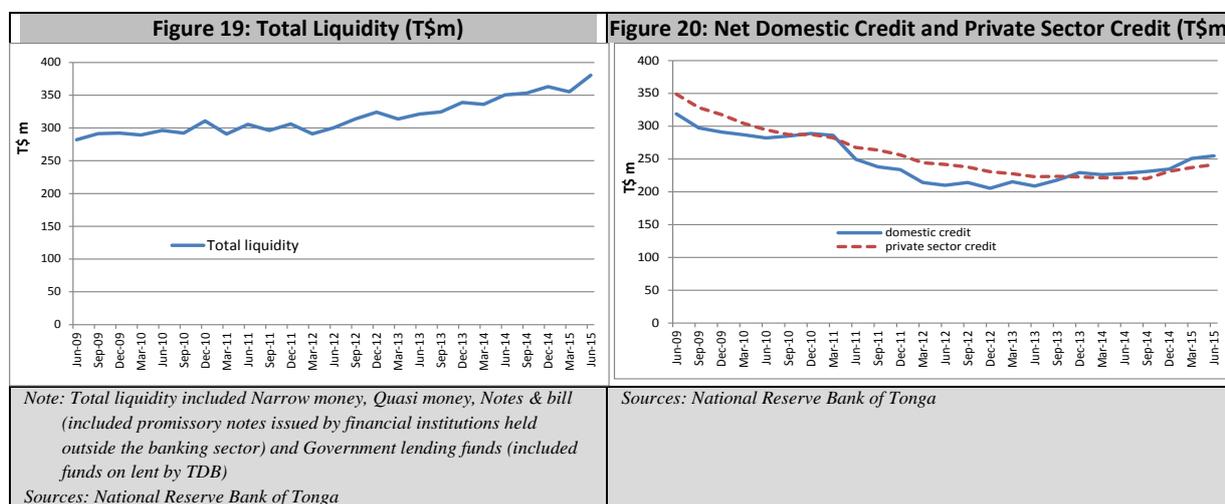
Movements in the trade balance in Tonga are dominated by fluctuations in imports. Import payments rose strongly in the June quarter 2015 to be 23% higher than the June quarter of 2014. Imports were stronger across a broad range of consumption, intermediate and capital goods. The increase in imports was associated with greater demand for imported goods due to the Coronation. Strong imports, combined with relatively weak export receipts, caused a deterioration of the trade balance in the June quarter. The trade balance is expected to be fairly stable in 2015/16, with imports supported by the Tupou College Anniversary. The trade balance is expected to improve in later years as imports fall back and as export growth strengthens through better yield for squash.

Total remittances receipts at the end of June 2015 were 16 percent higher than previous quarter and around 2 percent higher than the same period in 2014. The quarterly increase was mainly due to preparation for the church conferences and Coronation. This helps improve the current account balance and lower the current account deficit.

Gross official foreign reserves held by the NRBT were \$311.7 million as of the end of September 2015, the highest level recorded over the history of Tonga's official foreign reserves. Foreign reserves increased by T\$20 million through the September 2015 quarter. The rise in foreign reserves during the review period was mainly due to receipts of foreign grants which more than offset import payments. Gross foreign reserves are now equivalent to 8.8 months of import cover, which is well above the minimum range of 3 to 4 months set by the NRBT.

MONETARY AND FINANCIAL SECTOR

Total liquidity in the banking system for June 2015 increased by 7 percent from March, and was 8 percent higher than June 2014. The increase in liquidity resulted from higher deposits over the quarter, consistent with the rise in foreign reserves. Banks increased their lending over the 2014/15 year as evidenced by 12 percent increase in domestic credit. Lending to both private sector and Public Enterprises increase by \$19.8 million and T\$5.8 million respectively compared to June 2014.



Annual inflation at the end of September 2015 was -1.9%. This is a significant decline in annual inflation from 0.2 percent in the previous quarter. Local prices increased while imported prices decreased compared to a year ago – local prices are 3.2 percent higher, and imported prices are 5.2 percent lower. Higher local prices were due to increase in the prices of root crops, fruits and vegetables and fish. Lower imported prices were contributed by lower prices for both food and fuel.

Domestic oil prices (both petrol and diesel) have decreased. The declines are due to falls 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 reflected in lower imported prices for Food and Transportation and Household Operations components of the CPI, down by 3 percent and 8 percent respectively.

Inflation is anticipated to gradually increase through the forecast period due to a gradual increase in global oil prices, as supply conditions normalize. However, there is still substantial uncertainty about the outlook for global commodity prices.

In the September 2015 quarter, the Pa’anga appreciated slightly against the New Zealand dollar and Australian dollar, but depreciated strongly against the US dollar. This movement is due to changes in trading partner economies, with falls in global commodity prices leading to falls in the NZD and AUD. The USD has been appreciating as the economy strengthens and the Federal Reserves gets closer to raising interest rates. The Pa’anga has depreciated against the US Dollar from T\$1.75/\$1 to T\$2.23/\$1 at the end of September. 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, in the case of US dollar, benefits the remittances recipients as recipients in Tonga would receive more remittances in Tongan pa’anga sent from the US while it is not in the case for Australian and New Zealand dollars.

