

BACKGROUND

The five main island groups of the Kingdom of Tonga have a total land area of about 750 square kilometers and are spread across 360,000 square kilometers of ocean. The population in 2000 was an estimated 100,000, two thirds of whom live on the main island of Tongatapu, which contains the capital, Nuku'alofa. Substantial net outward migration keeps the population growth rate down to about 0.3 per cent per year; and Tongans living in New Zealand, Australia, and the United States are a source of substantial remittance flows.

Tonga ranks fourth amongst PDMCs on the Human Development Index scale, and lowest in terms of the Human Poverty Index (ADB 2001). GDP per capita was US\$1,510 in 1999/2000. Life expectancy is 68 years; the adult literacy rate is 99 percent; and the infant mortality rate is 19 per 1,000. Primary education is compulsory and virtually universal, and a large proportion of children proceed to secondary and tertiary education. The extended family is the cornerstone of Tongan society, which has a common language and customs and is hierarchically structured.

Tonga is a constitutional monarchy. The constitution was promulgated in 1875 and last amended in 1974. It calls for the separation of the legislature, the executive, and the judiciary. The King, as head of State, appoints the members of the Privy Council from among members of the Cabinet and the Governors of Vava'u and Ha'apai; they assist him in running the country.

The Cabinet consists of the prime minister and nine ministers. The unicameral Legislative Assembly is composed of the members of the Cabinet, the other privy councillors, and representatives of the nobles and the people. The 33 hereditary nobles elect nine among themselves to the Assembly, and the people vote for nine of their own representatives.

Landholding in Tonga has several unique features that differentiate it from other Pacific island nations. In the late 19th century, there was a major reform of the land tenure system in which land was distributed to selected chiefs, who became hereditary nobles, and to adult male commoners. The reform guaranteed all adult males about seven acres of land, which could be passed on to the eldest son. Large estates were allotted to the nobles, out of which future land allocations would be made. This feature is now voluntary, rather than a mandatory obligation on the nobility. A central feature of customary tenure is that land cannot be alienated by private sale. Although the reform was equitable at the time, population growth has been such that over 30 percent of adult men are now without land. They are thus dependent on landholding members of their families for access to and use of land. At the same time, Tongans who are resident overseas hold substantial amounts of land, much of which is idle. The practice has developed of leasing customary land in exchange for cash payments, but many leases are informal, and the Constitution prohibits leases longer than 20 years. In addition to customary land, there is Government land that can be leased on longer terms of up to 50 years.

THE MACROECONOMIC ENVIRONMENT

Tonga's economy is the second most vulnerable of the PDMC group after Vanuatu, according to the Composite Vulnerability Index reported in Commonwealth Secretariat/World Bank (1999). Domestic drought, cyclones, and external economic shocks have caused considerable volatility in agricultural production and export of a small number of products: squash, vanilla, and fish account for more than three quarters of total exports. The economy remains highly

dependent on foreign aid and private transfers, the latter amounting to an average 25 percent of GDP.

Real GDP at market prices grew at an average annual rate of about 1 percent in the late 1980s and early 1990s. In the latter period, there was a short boom in squash exports to Japan, but this ended due to foreign competition and production and marketing problems. After growth at the modest rate of 2.9 percent in the fiscal year ending June 1995, the economy stagnated in the next two years, and registered a growth rate of only 1.6 percent in 1997/98. The inflation rate during these years hovered around 3 percent (Table 7.1).

Agricultural output was affected adversely by Cyclone Cora in December 1998, but processed food and building materials production expanded significantly, and real GDP increased by 3.1 percent in 1998/99. The economic growth rate accelerated to 6.2 percent in 1999/2000. This largely reflected expansion in the primary sector (especially fishing), which grew at 10.8 percent after two successive years of decline, and despite the collapse of squash prices; and in the commerce, restaurants, and hotels sector, which grew at 17.9 percent, due in part to millenium celebrations. The tertiary sector as a whole grew by 5.6 percent, while the secondary sector expanded by 3.0 percent. There was also strong growth in private remittances. The inflation rate rose to 5.3 percent as a result of higher world prices for imports.

For the fiscal year ending 30 June 2001, it was projected that real GDP at market prices would increase by 3.0 percent. The expected growth slowdown was attributed to a drop in the primary and tertiary sector growth rates to 1.3 and 3.2 percent, respectively. Government services were projected to expand by 10 percent as a result of a 20-percent cost-of-living adjustment, but reduced activity in the commerce, restaurants, and hotels sector was likely to offset this. Growth in the secondary sector was projected to accelerate to 5.4 percent as construction activity picked up. The inflation rate for the year was projected to rise to 7.0 percent on the back of higher oil prices and nominal depreciation of the *pa'anga*, the Tongan currency (T\$).

Fiscal policy in the 1990s was prudent, in that aggregate fiscal discipline was maintained, although allocative efficiency

Table 7.1

Macroeconomic Indicators for Tonga, 1994/95–1999/00 ^a

	1994- 1995	1995- 1996	1996- 1997	1997- 1998	1998- 1999	1999- 2000
Output and prices			(percent change)			
Real GDP	2.9	-0.2	-0.1	1.6	3.1	6.2
Consumer prices (period average)	0.4	2.8	2.0	3.0	3.9	5.3
Central Government Finance			(in percent of GDP)			
Revenue ^b	26.6	26.4	29.5	28.8	26.1	26.9
Grants (cash only)	—	—	1.9	1.6	0.5	0.4
Current expenditure o/w Wages	22.9	24.4	28.1	29.3	26.7	27.0
Development expenditure (cash only)	—	—	—	15.1	14.9	14.2
Overall Balance	-3.5	0.8	-4.8	-2.5	-0.2	-0.4
Financing	3.5	-0.8	4.8	2.5	0.2	0.4
External loans (net)	3.6	0.0	-0.1	1.5	1.4	1.2
Tonga Trust Fund drawings	0.7	0.1	0.5	2.4	0.1	0.4
Domestic financing	-0.7	-1.0	0.5	-0.2	-0.3	0.3
Banking system	-0.1	1.0	0.5	-0.2	-0.3	0.3
Other	-0.6	-2.0	0.0	0.0	0.0	0.0
Money and credit (end period)			(percent change)			
Broad money (M2)	17.1	2.8	14.1	2.4	15.0	8.3
Total domestic credit	39.3	13.8	14.8	20.0	1.6	8.8
Private sector credit	38.2	9.5	11.4	21.0	2.1	7.0
			(in percent)			
Average deposit interest rate (end of period)	4.8	4.9	5.1	5.1	4.8	4.6
Base lending rate (end period)	9.0	9.0	9.0	9.0	9.0	9.0
Balance of Payments			(in millions of US dollar)			
Exports, f.o.b.	17.1	12.7	13.2	11.9	12.1	10.9
Imports, f.o.b.	-73.8	-66.5	-59.9	-78.9	-55.5	-62.6
Private Transfers (net)	32.1	36.3	36.5	37.7	37.4	—
Current account balance ^c (incl. of official transfers)	-22.1	-10.7	-1.5	-19.3	-1.0	-10.1
(in percent of GDP)	-13.2	-5.9	-0.8	-11.1	-0.6	-6.3
Overall Balance	-9.6	0.6	2.4	-12.1	7.2	-5.9
Gross International Reserves						
Official Reserves (US\$mn)	23.5	24.2	26.2	14.2	21.4	15.6
In months of imports						
of goods	3.8	3.8	3.2	2.4	3.3	2.3
External Debt			(in percent)			
External Debt/GDP	38.1	33.6	36.2	38.6	43.8	43.7
Exchange Rate						
Pa'anga/US\$ (period average)	1.28	1.26	1.23	1.35	1.58	1.64
Real effective exchange rate 1990=100	103.6	105.2	109.6	111.9	101.1	103.0

— Not available

a. Tonga's fiscal years are July to June

b. Revenue includes transfers from revolving funds, local community contributions and others

c. Includes current official transfers

Source: NRBT 1999; IFS

was not. The Government adhered to an implicit fiscal rule of achieving a zero recurrent balance, with limited reliance on domestic bank financing and drawdowns from the Tonga Trust Fund. Financing of capital expenditure generally came from external concessional loans. The overall fiscal deficit fell from 4.8 percent of GDP in 1996/97 to 0.2 percent in 1998/99, and then increased slightly to 0.4 percent in 1999/2000. However, the deficit increased to an estimated 2.6 percent in 2000/2001. Revenue was below the budget estimate, while pressure on the expenditure side was created by the civil service wage rises, a capital injection for a public enterprise, and payments to a foreign telecommunications company. Consequently, there was unusually heavy reliance on domestic bank financing, and nonwage expenditure was compressed further, compromising allocative efficiency. There was in addition an estimated T\$30 million unfunded liability arising from the civil servants' retirement scheme introduced in 1999.

The National Reserve Bank of Tonga (NRBT) has pursued the twin objectives of maintaining gross foreign reserves at three months of imports or more, and inflation at less than 3 percent. It monitors private sector credit growth and has used both indirect and direct monetary policy instruments, with the emphasis recently shifting to direct controls because of the weakness of NRBT's balance sheet (see below). The inflation target was met up until 1998/99, and the foreign reserves target until 1997/98. In recent years, inflation has accelerated because of drought, higher world prices, and currency depreciation. In 1998/99, foreign reserves recovered from the 1997/98 drop because of a tightening of monetary policy and increased aid flows; but fell again the following year, because of a widening trade deficit and a decline in capital flows. Gross official foreign reserves in mid-2001 covered less than two months' imports of goods and services. The balance of payments had deteriorated, largely because of a turnaround in the net services account from surplus to deficit, reflecting a decline in tourism receipts, a rise in transportation costs, and the impact of payments by the telecommunications sector. The capital account surplus also fell because of outflows of private capital and a decline in official concessional loans.

Broad money increased by 15.0 percent in 1998/99 and 8.3 percent in 1999/2000, largely because net foreign assets built up as NRBT contained domestic credit growth (Table 7.1). Money supply growth rose to an estimated 35.8 percent in 2000/2001. The latter increase was driven by a 42-percent rise in domestic credit. Net credit to the Government rose rapidly in line with financing of the fiscal deficit, while credit to the private sector grew by around 26 percent. Net foreign assets declined. Monetary policy had been tightened early in the year in response to declining foreign reserves: NRBT raised the reserve requirement ratio from 12 to 15 percent and the minimum lending rate from 9 to 12 percent. Credit ceilings were also approved by the Privy Council in July 2000. However, monetary policy eased during the latter half of the fiscal year.

Since July 2000, the pa'anga has been pegged to a basket of currencies that includes the Japanese yen in addition to the US, Australian, and New Zealand dollars. From mid-1998, the exchange rate was allowed to depreciate. The real effective rate depreciated by about 11 percent to the end of 1999, but appreciated slightly in 2000 because of Tonga's accelerating inflation rate. Tonga has an open current account. Capital account flows have to be reported to NRBT and approvals depend on the level of foreign reserves. Banks are permitted to offer foreign currency accounts to depositors.

Tonga is heavily dependent on external savings, which take the form of private remittances and official development assistance. These transfers have allowed Tonga to maintain high levels of consumption and negative domestic savings, estimated at -15.1 percent of GDP for 1994/95 (the latest recorded figure). Gross domestic investment was estimated at 13.7 percent of GDP in that year, so that on the available data Tonga faces a substantial savings-investment gap of around 30 percent of GDP. To reduce this heavy reliance on external transfers and aid, Tonga needs to promote more domestic savings. A more efficient financial system would assist in this process. Public enterprise reform would also help. There are more than 35 public enterprises, many of which are involved in commercial activities. Only four pay dividends to Government and a number receive budget support.

Early in 2000, the Tongan Cabinet committed itself to the design and implementation of a comprehensive reform program aimed at promoting private sector-led economic development. This will involve tax and tariff reform, improving the enabling environment for the private sector, and reform of the civil service and public enterprises with a view to increasing the efficiency and effectiveness of the public sector. If the reform program can be implemented successfully within a stable macroeconomic environment, economic growth at a sustained rate of 3 percent or more can be expected. This in turn will stimulate financial sector development.

THE STRUCTURE OF THE FINANCIAL SECTOR AND INSTITUTIONS

The formal financial system of Tonga comprises NRBT, three commercial banks, the Tonga Development Bank (TDB), four life insurance firms, and three foreign exchange dealers. NRBT was established in 1989 and performs the regular central banking functions: the licensing of financial institutions, prudential regulation and supervision of the licensed commercial banks and TDB, implementation of monetary and exchange rate policy, and management of the country's foreign exchange reserves. There is also a Civil Service Pension Fund that was set up in 1999 to replace the previous noncontributory pension scheme for public servants. Money and securities markets are presently a small part of the financial system. Informal financial enterprises also operate.

The Bank of Tonga (BOT) is a locally incorporated bank established in 1974, owned by the Westpac Banking Corporation (Westpac) (60 percent) and the Government (40 percent), and managed under contract by Westpac. The other two commercial banks began operations in late 1993: the ANZ Bank (ANZ) is a branch of the Australia and New Zealand banking Group of Australia; and the MBf Bank is a locally incorporated joint venture, with the MBf Finance Company of Malaysia holding 91.25 percent of the shares and local shareholders holding the remainder.

There is a bank branch or agency for every 8,300 people. The use of banking services is widespread on Tongatapu and

Vava'u. However, in the more remote parts of Tonga (for example the Niuas and many islands in the Ha'apai group), the use of money in day-to-day transactions is less common. BOT maintains its head office in Nuku'alofa and has branches elsewhere in Tongatapu, and on Vava'u, Ha'apai, and 'Eua. ANZ has its main branch on Tongatapu and operates a branch on Vava'u; and MBf maintains its head office on Tongatapu with a branch on Vava'u. TDB maintains its head office on Tongatapu, as well as branches on Vava'u, Ha'apai, 'Eua, Niuatoputapu and Niuafu'ou. In the semiformal sector there are 23 credit unions covering the island groups of Tongatapu, Ha'apai and Vava'u.

The assets of the three commercial banks constitute around 56 percent of the total assets of the financial sector, which reached T\$140 million in mid-2000 (Table 7.1). BOT is the largest bank, with 31 percent of the total assets; ANZ has 20 percent; and MBf has 5 percent. NRBT holds about 23 percent of total assets, and TDB the bulk of the rest. TDB was established to develop the agriculture and rural sectors, using resources obtained mainly from concessional external borrowing and bilateral assistance grants. It does not generally accept deposits, with the exception of two branches on the remote Niuas, where it took over from BOT.

An Interbank Payment System is functioning in Nuku'alofa and representatives of the banks based there come to NRBT at 12 noon each day to exchange checks. The net amounts are settled through the NRBT accounts, which are in ledger form. Banks in the outer islands have no form of centralized clearing and their checks are sent by post to head office of the relevant bank for clearing. This can take weeks or even months. NRBT is aware of the situation and plans to establish regional clearing facilities as a first step and then to implement transfers electronically.

Credit Unions are covered by the Credit Union Act of 1977 and are registered with the Registrar of Cooperatives. They take deposits from members and provide credit at low cost. The members own and manage their own credit union and are responsible for formulating their own policies. The act requires that each union elect a board of directors of not less than five members.

Table 7.2
Total Assets/Liabilities of the Financial Sector, 1994–1999
 (percent)

	1995	1996	1997	1998	1999 ^a
National Reserve Bank of Tonga	25.0	24.4	22.7	22.6	23.6
Commercial Banks	51.9	52.5	54.4	56.5	57.9
Bank of Tonga	—	—	34.9	30.8	—
Australia New Zealand Bank Ltd	—	—	13.3	20.4	—
MBf Bank	—	—	6.2	5.3	—
Nonmonetary Financial Institutions	23.1	23.2	22.9	20.9	18.5
Tonga Development Bank	21.3	21.6	21.4	19.5	15.2

—Not available

a. As at September 1999

Source: NRBT 1999

PERFORMANCE OF COMMERCIAL BANKS

At the end of the 1999/2000 financial year, 97 percent of the commercial banks' outstanding portfolio was held with the private sector, and 3 percent with the public sector (mostly nonfinancial public enterprises). Forty-three percent of the private loans were to the manufacturing, transport and communications, commerce and trade, construction, and services sectors; 32 percent were for housing; 5 percent were for agriculture; and the rest was miscellaneous lending, including to nonprofit bodies.

The commercial banks as a group showed a pretax profit of 4.3 percent of average assets in 1998/99, compared with 2.9 percent in 1997/98 and 2.2 percent in 1996/97. Total operating income in 1997/98 was 9.0 percent of average assets. The bulk of this income came from loans, with net interest income constituting 62.2 percent of total operating income. Foreign exchange transactions accounted for 29.4 percent. The average net interest margin for the commercial banks was 6.6 percent in 1997/98.

There are major differences in the performance of individual banks. Both BOT and ANZ have sound portfolios and adequate capitalization and have been profitable,

especially in recent years, since expenses were lowered and portfolios improved through better risk assessment and lending practices. In contrast, MBf has a large proportion of nonperforming loans (about 40 percent in 2000), suffered losses as a result of credit card fraud, and has never returned a profit. TDB recorded low profits or losses through the 1990s and towards the end of the decade began a major restructuring (see below). The consolidated risk-weighted ratio for all commercial banks of 33.7 percent at the end of 1999 therefore masks wide disparities in the ratios of individual banks.

FINANCIAL DEEPENING AND INTERMEDIATION

There was some deepening of Tonga's financial sector in the 1990s. The ratio of broad money to GDP increased from 33 percent of GDP in 1994/95 to 37 percent of GDP in 1999/2000. During the same period, the ratio of narrow money to broad money fell from 35 percent to 29 percent, reflecting growth in time deposits in particular. Within the narrow money category, there was a shift away from holding currency toward using checking accounts (Table 7.3).

Loans to the private sector grew from 18 percent of GDP in 1993/94 to 33 percent in 1999/2000. The relatively modest share of loanable funds used for private sector credit is also reflected in the fact that total domestic credit accounts for only around half of the total banking sector assets. The commercial banks believe that the risks associated with many perceived investment opportunities are too high.

Interest rates on both deposits and lending fell in the 1990s. The weighted average deposit rate dropped from 7.0 percent in 1990/91 to 4.8 percent in 1999/2000. The base lending rate (lowest rate charged) fell from 12.5 percent in 1990/91 to 9.0 percent by 1992/93 and stayed at that level for the rest of the decade. Both savings and lending rates have generally been positive in real terms over the 1990s, except for 1990/91, when both rates were negative, and 1999/2000, when the real deposit rate became negative (Table 7.4). The net interest margin (net interest income as a percentage of average earning assets) for the commercial banks has averaged around 6 percent over the

Table 7.3
Financial Intermediation Statistics, 1994/95–1999/00

	1994- 1995	1995- 1996	1996- 1997	1997- 1998	1998- 1999	1999- 2000
	(in millions of pa'anga)					
Money Supply (M2)	65.0	66.8	76.2	78.0	89.7	97.2
Narrow Money (M1)	22.8	20.4	20.9	21.3	24.7	27.8
Currency outside banks	7.4	6.9	6.3	6.1	7.3	8.0
Demand Deposits	15.4	13.5	14.6	15.2	17.3	19.8
Quasi Money	42.2	46.3	55.3	56.7	65.0	69.4
Savings Deposits	20.5	20.7	20.8	22.3	24.0	24.6
Time Deposits	20.4	25.4	29.3	31.3	36.9	40.8
	(in percent)					
Growth of Demand Deposits	23.2	-12.3	8.1	4.1	13.8	14.5
Growth of Time Deposits	29.9	24.5	15.4	6.8	17.9	10.6
Currency in percent of GDP	3.4	3.0	2.7	2.5	3.0	3.1
Narrow Money in percent of GDP	11.5	9.8	10.1	9.7	10.4	10.6
Broad Money in percent of GDP	32.7	31.9	36.7	35.6	37.8	37.2
Private Sector Credit (percent of GDP)	24.4	25.7	28.3	32.9	32.9	33.1
Private Sector Credit (percent of total credit)	102.7	98.8	95.9	96.8	97.3	96.6
Currency (per cent of broad money)	11.6	10.4	8.9	8.1	8.5	8.2
Narrow Money (percent of broad money)	35.1	30.7	29.4	28.4	28.8	28.6
Quasi Money (percent of broad money)	64.2	69.3	70.6	71.6	71.2	71.4
Demand Deposits (% of narrow money)	67.5	66.2	69.9	71.4	70.3	20.4
Total Domestic Credit/ Banking Sector Assets	41.7	45.5	49.3	54.3	—	—

— Not available

Source: NRBT 1999

past few years. The interest rate spread dropped in 1994/95 following the entry of ANZ and MBf into the market, and then rose slightly to around 4 percent in the late 1990s. By PDMC standards, this is relatively low, probably because of lower risks and costs.

Table 7.4
Nominal and Real Returns on Savings and Lending Rates

	Weighted Average Deposit Rates	Average Lending Rate	Inflation Rate	Real Savings Rates	Real Lending Rates	Interest Rate Spread
1990/91	7.0	12.5	13.0	-6.0	-0.5	6.5
1994/95	4.5	9.0	0.4	4.1	8.6	4.5
1995/96	4.9	9.0	2.8	2.1	6.2	4.1
1996/97	5.2	9.0	2.0	3.2	7.0	3.8
1997/98	5.3	9.0	3.0	2.3	6.0	3.7
1998/99	5.0	9.0	3.9	1.1	5.1	4.0
1999/00	4.8	9.0	5.3	-0.5	3.7	4.2

Source: NRBT 1999

COMPETITION

Until 1993, the Tongan financial sector consisted of BOT and TDB. As a result, there was little competition, with both institutions enjoying attractive interest margins and profitability. After 1993, competitive pressures increased with the entry into the market of ANZ and MBf under Tonga's open entry system. ANZ's entry brought in new products and BOT improved its services and products in response. TDB took on more commercial lending functions. The competition brought a decline in lending rates; but rates subsequently stabilized, as MBf's financial position deteriorated, and TDB reduced its portfolio and raised interest rates to reflect the risks involved in lending to agriculture. There has been little competition on the deposit side because of the high level of liquidity in the system.

The Tongan financial sector may not be able to support more than two commercial banks, given the size of the market and slow GDP growth. The restructuring of TDB, if it were combined with higher growth in the economy, could over time bring more competition, but TDB would need to upgrade its services and products to compete successfully with the commercial banks' products. The setting up of several foreign

exchange bureaus has markedly increased the competition in foreign exchange transactions.

With excess liquidity in the system, only a few nonbank financial institutions (NBFIs), and no securities market, there is little competition for banking sector deposits. The demand for financial services needs to grow in Tonga to encourage the development of NBFIs and securities markets, in order to broaden the range of services and stimulate competition.

NONBANK FINANCIAL INSTITUTIONS

Tonga Development Bank

TDB was established in 1977, taking over the Government's Agricultural Credit Scheme, Fisheries Loan Scheme, and Small Scale Industries Fund. Its mandate on establishment was to service and respond to the needs of small businesses, outer islands, and women and other disadvantaged groups.

TDB has carried out this mandate by progressively diversifying its products and services. In 1994, it went into commercial lending and housing and personal loans. TDB also considered setting up a separate banking subsidiary to provide trade finance for import export business. There were several justifications for these proposed moves. First, there was a perceived need to serve clients who were seeking full banking services and who might have been lost to competing banks. Second, securities already pledged and held by TDB could not legally be split with other banks. Third, commercial banks had become active in lending to sectors traditionally served by TDB, such as squash production and hotel and motel construction.

In addition, TDB moved from relying on low-cost aid funding to partly funding its borrowing requirement from new funding products. The Government guarantees all borrowings and assumes the foreign exchange risk. TDB started issuing TDB promissory notes to local investors in July 1993. The terms ranged from 30 days to five years at rates ranging from 3.5 percent to 7 percent. Interest is paid out on maturity and semiannually for terms greater than 180 days. At the end of

1998, the total fresh funds raised from promissory notes since 1993 was more than T\$18.4 million, but this has since been reduced to an outstanding balance of around T\$3.3 million. In July 1994, TDB began issuing bonds with three-year and five-year maturities, at rates of interest ranging from 6.25 percent to 7.25 percent. At the end of 1998, the total funds raised from these bonds totaled T\$7.0 million. The total funds raised by TDB's domestic borrowings from its inception in 1993 to December 1998 totaled T\$55.5 million. These have included fresh funds as well as rollover funds.

TDB was once considered to be one of the most successful development banks in the region. However, during the late 1990s it became apparent that many of the loans on its books were nonperforming. Profitability fell from a peak of T\$667,000 in 1994 to a loss of T\$3.8 million in 1998 (Table 7.5). The major problem was that, in trying to compete with commercial banks, TDB had taken on riskier lending, had neglected the quality of its portfolio, and had taken insufficient action to collect on loans. The increased cost of borrowing from the market had also led to narrowed margins. In 1998, action was taken to clean up the portfolio, which consequently fell to T\$32.8 million by the end of the year. Loan loss provisioning to large clients had more than doubled and some debts were written off.

Some of TDB's arrears problems were related to its image as a cheap source of finance and an institution that did not need to make a profit because it was an instrument of the Government's development policy. TDB had high risk, made small loans with low interest rates, and was seen as different from commercial banks that would take firm steps to get their loans repaid.

A summary of lending by TDB indicates that it plays a significant role in private sector development. It funded around 80 percent of all loans for agriculture and industry in the private sector in the whole of Tonga for the period June 1990 to June 1998. Project finance was provided for squash and vanilla production, fishing, hotels, motels, and retail and small manufacturing businesses. Since 1998, TDB has started pricing its loans according to risk, and providing incentives for borrowers to improve their risk rating. In addition, it has been reviewing procedures, streamlining administration, and

Table 7.5
TDB: Operating Performance and Statistics, 1995–1999

	1995	1996	1997	1998	1999 (proj.)
Total Income (T\$'000)	5,078	4,875	5,017	4,741	5,392
Total Expenses (T\$'000)	4,411	4,768	5,763	8,519	4,787
Net Profit/(Loss) Before Tax (T\$'000)	667	107	-746	-3,778	605
Total Assets (T\$'000)	46,505	46,639	47,023	45,957	45,694
Share Capital (T\$000)	9,572	9,781	9,980	10,083	10,183
Shareholders Funds (T\$'000)	13,831	14,249	13,865	10,299	13,862
Provisions for Loan Losses (T\$'000)	-4,598	-5,464	-6,865	-9,965	-10,405
Interest Spread (percent)	5.37	3.72	4.34	2.74	1.95
Earnings Spread (percent)	2.72	1.39	2.07	0.80	0.22
Loan related Expenses to Total Expenses (percent)	48	51	60	72	48
Staff Expenses to Total Expenses (percent)	26	23	20	14	28
Administration Expenses to Total Expenses (percent)	27	26	21	14	24
Capital Adequacy (percent)	30	30	29	22	30
Capital Adequacy Risk Weighted (percent)	29	31	28	27	28
Profit/(Loss) to Average Shareholders' Funds	4.7	0.7	-5.3	-31.3	5.0

Source: TDB 1997, 1998

focusing on other ways to assist borrowers. Linkages with complementary services are being established, such as with business advisory services to help farmers and small businessmen with bookkeeping, with the Ministry of Agriculture to provide extension services, and with Tonga Trade to help identify potential markets.

TDB's management is giving priority to improving the arrears situation. In 1996, it established an Arrears Task Force Unit, which led to some temporary improvement in the situation. However, the amount in arrears deteriorated from 43 percent in

1997 to 49 percent in 1998 (Table 7.6); in 1999, the Task Force was replaced by a Recovery Unit with 16 staff.

One of the critical components of successful development banking is the establishment and maintenance of strong governance processes embodied in a strong board able to provide support and guidance to senior management and to set a clear direction. It is generally accepted that there is a need for a balance between private sector input and expertise and Government representatives reflecting the wishes of the Government as 100-percent shareholder. The existing board consists of seven directors including three Government representatives (the Minister of Finance as the chairman, the Minister of Labour, Commerce and Industries, and the Director of Agriculture); three private sector representatives; and the TDB Managing Director.

CIVIL SERVICE PENSION FUND

The Civil Service Pension Fund (CSPF) was established under legislation passed in 1998 and became operative in 1999. The CSPF board consists of the Prime Minister, the Minister of Finance, the Attorney General, two members elected by civil servants, and the chief executive of the scheme.

The first year of operations focused on building a database of civil servants who will be contributors to the fund, and on agreeing on the transfer value with the Government. The transfer value is currently estimated at T\$32.4 million for 4,300 people and is posing severe funding problems for the Government. Starting in 1999, both the employee and employer contributed 5 percent of earnings. The Fund amounted to T\$3 million at the end of 1999. The employees may contribute more, but any additional amount will not be matched by the Government. Payment on retirement is through a lump sum, but members are asking that arrangements be made for them to draw a pension.

The next task is to determine an investment policy for the CSPF, which will need to be approved by NRBT. Employees will not be able to withdraw funds for direct investment, such as house purchases, or for direct equity investment. The

Table 7.6

TDB: Arrears Summary 1995–1998

	1995	1996	1997	1998
No. of accounts in Arrears	4,053	3,417	2,767	2,887
Percent of No. in Arrears	42	41	37	42
Amount in Arrears (T\$'000)	6,952	6,516	7,243	8,723
Balance in Arrears (T\$'000)	19,209	14,452	18,639	20,681
Percent Balance in Arrears	50	35	43	49
Total Portfolio	37,979	41,089	43,000	41,802
Percent Hard Core Arrears	13.2	13.8	13.0	14.7

Source: TDB 1997, 1998

important requirement is to ensure that funds are well invested and are available when contributors reach retirement age. It is likely that management of the fund's assets will be split up and allocated to overseas fund managers. Considerable help from AMP (an Australian firm) was received during CSPF's establishment, so it is likely that its advice will be sought in appointing investment advisors. The fund will also invest in domestic Government and development bank bonds and notes and will hold funds in local banks as term deposits. There are no plans at present to invest in domestic equity, although this would be possible, in the longer term, if suitable investments were available.

Tonga Trust Fund

The Tonga Trust Fund was established in 1989 with the proceeds of passport sales to foreigners. It is an official account held mostly offshore and separate from foreign reserves. It is managed by a Board of Trustees chaired by the Prime Minister. This board determines investment policy after consultation with the Privy Council. An external investment adviser manages the investment portfolio. The Fund is used to finance specific public investment projects, and occasionally to fund current budget expenditure. The Fund's closing balance in June 1998 was T\$33.5 million, of which T\$32.3 million were invested overseas.

LEGAL AND REGULATORY FRAMEWORK AND SUPERVISION

NRBT's role, authority, and responsibilities are set out in the National Reserve Bank Act of 1989 and the Financial Institutions Act of 1991 (amended in 1998). NRBT's Board of Directors consists of the Prime Minister, who is the chairman; the Attorney General, who is deputy chairman; the NRBT Governor; Her Royal Highness Princess Salote Pilolevu Tuita; a representative of the private sector; and the Secretary of Finance (ex-officio).

The development of a supervisory capacity in NRBT started in 1993. The Financial Institutions Act pertains to licensing, capital requirements, limits on lending to related parties, and limits on risks to single borrowers. The 1998 amendment gave NRBT the ability to flexibly issue prudential regulations, in line with international standards. It follows the Basle core principles in establishing the capital adequacy ratios required for banking institutions, and has issued prudential guidelines setting out broad policies that financial institutions are required to adhere to. Regulations have been issued in line with international practice on loan classification, loan loss provisioning, and interest accrual. NRBT has also prepared risk-weighted capital adequacy ratios of 15 percent for commercial banks and 18 percent for TDB.

NRBT monitors and evaluates the overall strategies, policies, and performance of financial institutions through a regular reporting system. The banks are monitored for compliance with the terms of their licenses and with prudential standards, such as capital adequacy limits and credit exposures. The majority of regulations are properly functional and banks can generally comply. Off-site supervision consists of the analysis of monthly reports that banks are required to submit on their financial condition, and some on-site supervision has been carried out. However, there is a need to enhance the capacity of NRBT to conduct banking supervision effectively. In particular, there is considerable concern about the financial status of MBf, which recorded ratios of nonperforming loans to total loans and total capital of 26 percent and 167 percent, respectively, in 1997/98. It is doubtful that the parent company will be able to support

further injections of capital. Indeed, it appears that the parent itself may file for bankruptcy in Malaysia. The performance of MBf has brought to light the weaknesses in the existing legislation dealing with insolvent banks.

NRBT's Financial Institutions Department is small, and the average length of staff experience too short, to enable it to operate efficiently. The department needs strengthening through training.

At present, there is no legislation specifically regulating foreign investment. Application of existing Licenses and Industrial Development Incentives Acts has been nontransparent and discretionary, and has therefore discouraged foreign investors. However, the Foreign Investment Advisory Service of the International Finance Corporation and the World Bank has undertaken a diagnostic review of these acts and made recommendations for the introduction of foreign investment regulation.

Although only BOT offers some investment advisory services at present, there are no guarantees that this situation will continue. Without appropriate legislation and regulation, the authorities may be unable to prevent fraudulent or inappropriate behavior by unscrupulous organizations and individuals.

DEVELOPMENT OF MONEY AND BOND MARKETS

In the early stages of financial development, the central bank usually relies on direct instruments of monetary policy. As the market economy increases in sophistication, the bank moves to greater reliance on indirect instruments, influencing the level of bank reserves through financial markets. Tonga made considerable progress in this regard during the 1990s: interest rates were liberalized in July 1991; NRBT started weekly auctions of its own notes in 1993, which were expected to be the primary method for influencing banking system liquidity; and a reserve requirement was introduced in 1993. However, in the late 1990s, NRBT was compelled to use direct monetary policy instruments to control money growth.

NRBT bills originally ranged in maturity from one to three months and could be purchased by any domestic or foreign

entity, though in practice most of them were bought by the commercial banks and some by TDB. However, financial constraints forced NRBT to stop issuing three-month bills at 5.5 percent in 1998, leaving only one-month bills at a below-market rate of 3.5 percent. The financial constraints arose from the fact that the income position of the NRBT had worsened since its establishment, because of a lack of financial support from the Ministry of Finance and the gradual loss of foreign reserves.²¹ At present, therefore, NRBT auctions one-month bills on a weekly basis. It selects the quantity and takes tenders. NRBT has an internal yield curve and sells at a price that meets the yield curve where the amount required is sold. There are no central or computerized systems to support the issue or trading of these instruments.

The reserve requirement introduced in 1993 initially required banks to place 5 percent of their domestic currency deposits in a zero-interest account with NRBT. The requirement was raised to 10 percent in December 1995, following a rapid decline in foreign reserves that year, and was accompanied by an increase in the minimum lending rate. The reserve requirement was raised again to 12 percent in October 1998, and to 15 percent in September 2000, to protect the level of foreign reserves. The effectiveness of the reserve requirement has been somewhat impaired because distribution of liquidity across the banks is highly uneven, with most of it concentrated in the BOT. Reserve requirements are also used for prudential purposes.

NRBT also auctions five-year Government bonds. The Government determines the quantity and offers are accepted on a price basis. There is no regular program or auction: bonds are issued as and when the Government needs the financing. NRBT gives priority to private investors and there are insufficient bonds available for commercial banks and companies to purchase. At present, the Government is redeeming bonds rather than rolling them over: T\$10.4 million

²¹ When NRBT was established, the net foreign assets position was transferred from BOT to NRBT largely by issuance of NRBT bills.

was outstanding in mid-1999. There are no restrictions on foreign ownership of bonds and to date an international issue has not been tried. All processes in the bond market are manual. The NRBT acts as registrar for the majority of issues and provides a buy-back facility.

Because of the shortage of NRBT instruments and Government bonds, there is no secondary market in these instruments and they are held to maturity. This has prevented the development of a proper yield curve, without which it is difficult for companies and investors to price debt issues. TDB issues Government-guaranteed bonds that are purchased by the same persons and institutions as those buying Government bonds.

NRBT started offering repurchase agreements (repos) on its notes and Government securities in 1993 to assist banks with their short-term liquidity needs. Repos are priced 2 percentage points above the minimum lending rate for the first ten days and 4.5 percentage points above after that. The minimum lending rate has been raised four times since 1995, the latest from 9 to 12 percent in July 2000. Fluctuations in liquidity have forced all banks to resort to this facility from time to time over the 1990s.

NRBT is not yet able to rely completely on indirect instruments for monetary control because of the above-mentioned weakness in its balance sheet. It has frequently been unable to sell the desired volume of notes to control liquidity, and consequently has had to use direct instruments of control. To contain the loss of foreign reserves in 1997/98, a 30-percent deposit cash margin was imposed on new loans (except to the export and tourism sectors); this remained in place until April 1999. In July 2000, the Privy Council approved the use of credit ceilings. Reliance has also been placed on moral suasion.

DEVELOPMENT OF DEBT AND CAPITAL MARKETS

A new Companies Act, modeled on the New Zealand act, was passed in 1999. It sets out the responsibilities of directors and company secretaries toward the company and the shareholders, and specifies the contents of the annual report

and accounts. It does not, however, deal with the contents of prospectuses or contain any requirement to issue one prior to a public offer.

The act differentiates between domestic companies and those that have more than 25-percent foreign ownership. Domestic companies do not have to be audited, provided the annual general meeting agrees. These companies also have minimal reporting requirements. Companies with more than 25-percent foreign ownership must file audited accounts.

The act makes it difficult for small companies to register, as there are very stringent rules on who can be appointed as the company secretary. None of the local accounting firms is interested in undertaking this role, as the duties placed on the company secretary are onerous. The new act requires companies to reregister, and those that fail to register will legally cease to exist. (The situation with regard to creditors of the ceased institution is not clear). It is believed that many small firms may not re-register as companies but will continue to do business as sole proprietors or partnerships. Compliance with the new Companies Act will be monitored by the Ministry of Labor, Commerce and Industry, and the registrar will have a team of company inspectors.

TDB insists on audited accounts for large loans and approximately 40 percent of the companies on their books are audited. However, the audits are not always timely: audited accounts may be up to one year late. It appears that less than 2 percent of business customers (by number) provide audited accounts. In general, small family businesses do not produce good in-house financial information, and the first step when the banks make a loan is to require them to produce profit and loss statements. Commercial banks indicated that local accounting firms are sound and standards are based on best international practice. There are around 10 chartered accountants practicing in Tonga. There is also a local society of accountants, but this does not have international recognition because it prefers to make membership inclusive of anybody involved in accounting, even if they are unqualified.

Tonga has no securities law and no regulatory body governing the issue of shares to the public by companies registered in Tonga, or the provision of intermediary services

and investment advice. The small number of companies that have issued shares to the public apparently advertised on television and through other media. While there is no reason to believe that any representations made by these companies were incorrect or fraudulent, there are no laws or regulations governing the amount or accuracy of information provided. As noted earlier, this lack of regulation of public issues could leave Tonga open to the type of abuse that has occurred in some other countries where fraudulent persons have established pyramid selling schemes.

Proper laws and regulations relating to public companies are critical to the proper operation of a stock exchange. These laws and regulations should deal with (i) information to be provided by companies that intend to issue shares to the public, and the responsibility of directors for the accuracy of such information; (ii) the protection of minority shareholders in the event of takeover; and (iii) the barring of insider trading. Such securities laws normally require the establishment of a regulatory body to produce regulations and monitor the implementation of the law. In Tonga, this role could be delegated to the Registrar of Companies and the inspectors established under the Companies Act.

In general, however, there are few public corporations, because Tongan companies are family enterprises that would often prefer to close down rather than appoint an outside manager or try to attract outside shareholders. The taxation system also discriminates against companies' paying dividends or building reserves. The personal tax rate is 10 percent, whereas the rate on corporate profits is 15 percent, rising to 30 percent for profits over T\$100,000. Companies that are owned by their managers therefore tend to pay high wages, rather than make profits and pay dividends. Companies also tend to split into smaller units to avoid the higher rate of tax. This is why there are so many "groups" in Tonga. The Government has undertaken a degree of corporatization of State-owned enterprises, but has not issued any shares to the general public.

In general, funds are available for companies with good business plans and/or a good management track record. The constraint is a lack of bankable projects.

MICROFINANCE

Unemployment for men in the formal sector was estimated at 15.2 percent in the 1996 census, and only one quarter of school leavers are able to find work. Thus, the creation of additional employment is a priority. Most of this will have to be generated in the informal sector, and microfinance services will need to be developed.

Informal Sector

The informal financial system is widespread in Tonga and includes traditional savings clubs. The system complements the formal system, and often acts as an intermediary in collecting savings of members and depositing them in the bank. There are an estimated 300 such schemes, mostly on Tongatapu. Traditional savings clubs are based on church affiliation, workplace groups, and community groups.

The informal financial system thrives because credit is in demand for traditional, family, and religious purposes. The system has low operating costs and meets the special needs of members of a group, by being conveniently located in the community and by providing a quick and simple service. Traditional items are accepted as collateral. Interest charges on loans are generally higher than those charged by formal financial institutions, but people are willing to pay, because they have a sense of ownership and because interest receipts are shared among members. Anecdotal evidence suggests that in most cases interest earnings are over 100 percent of the member's contribution. The repayment rate is high and risk is fairly low, since members know one another.

Tonga Development Bank

In addition to its normal lending activities, TDB has operated two credit schemes for financing private sector activities for people who have no ready access to finance and business advice. These targeted women and low-income households in the outer islands. The first, the Outer Islands Credit Project was funded by the International Fund for

Agricultural Development (IFAD), and operated over a five-year period that ended in December 1999. The total project cost was T\$6.9 million. The second, the New Zealand Overseas Development Assistance (NZODA) Outer Island Revolving Fund and Women's Development Fund (later re-named Borrowers' Diversification Fund) started in 1991 and is still operating. Education of borrowers and staff training were important elements of the project.

Total loan disbursements for the IFAD Project were T\$3.15 million, with an average loan size of T\$725. The NZODA scheme has disbursed loans of T\$195,392, with an average loan size of T\$1,033, to a total of 189 women's groups for traditional handicrafts, retail shops, fishing, agricultural projects, and boats. The loan terms and conditions were similar for both the IFAD and NZODA schemes, except that the NZODA scheme had a training prerequisite and focused on women. The guidelines were flexible to suit the financial needs of the target clientele. Both schemes accepted *tapa* or mats, personal assets, houses, and vehicles as security. The IFAD scheme had a maximum loan size of T\$2,000, and that of the NZODA of T\$5,000, both repayable over 12 to 24 months. Interest rates were identical, initially set at 8–10.5 percent and, after the restructuring of TDB at the end of 1998, 13.5–15 percent. The loans were subject to standard TDB processing, which many low-income households found hard to comply with.

Nongovernment Organizations (NGOs)

The Langafonua Women's Revolving Fund, an NGO, started in 1991 and is administered by a national association of women. The scheme was aimed at helping women make traditional handicrafts either for sale or for their own use. It caters only to women's groups (of at least three members) in Tongatapu, who must be endorsed by an extension officer as creditworthy. Interest of 10 per cent of the loan is charged up front, while each member must pay a T\$6 membership fee. There is no means testing to ensure targeting of loans to the relatively poor. Loans are repaid monthly at T\$50 per month over a 10-month period, with no penalty for late payments. Total

funds have now increased to T\$11,032. In 1999, there was a total loan portfolio of T\$2,491.

The Tonga National Youth Credit Scheme was implemented in cooperation with the South Pacific Commission, the International Labor Organization, the Regional Equitable Sustainable Human Development Program of the United Nations Development Programme, and the Government of Tonga through the Ministry of Education and the Tonga National Youth Congress (TNYC). This scheme was aimed at increasing participation of youth in income-generating activities and was launched as a pilot project in September 1993 with seed funding of T\$18,000. It commenced with a program of business training and unsecured loans of up to T\$1,000 with interest of 10 percent annually. By the end of 1999, 25 loans amounting to T\$24,000 had been approved for 24 groups with a total of 1,121 members. Ten loans had been fully repaid, while 11 loans were in arrears and four were current. A weakness of the scheme is that it is just one of many activities of the TNYC, and members of the Credit Committee are heavily committed to other duties.

Credit Unions

There are 23 active credit unions throughout Tonga that provide credit and savings services to 911 members. Of these, 16 are based in Tongatapu and are mostly community-based, while four are based in Vava'u and three in Ha'apai. In 1999, credit unions' total shares amounted to T\$383,973 and total outstanding loans to T\$223,897.

The credit union movement started prior to the enactment of its act: the Act to Regulate Credit Unions No. 4 of 1977. The first credit union was registered in 1980, and by 1990, the movement had grown to 62. However, the apex body, the Credit Union League, encountered management problems, and the number of unions declined in the early 1990s. The movement was revived in 1996 with the setting up of the new Credit Union League, under the supervision of the Department of Cooperatives and Credit Unions. The League has an office at the department and receives support from five Government staff, as well as the Credit Union Foundation of Australia and

the Hans Seidel Foundation. Credit unions hold great potential for reaching people in the outer islands.

NGOs, with the exception of Langafonua, are not involved in microfinance. Most are actively involved in general welfare and community projects.

With few employment opportunities in the formal sector, people's options are either to look for work overseas or engage in self-employment and other informal sector activities. The latter include women and men selling at the Tuimatamoana Flea Market on Saturdays and the growing number of people selling at the Talamahu market, as well as enterprising households selling imported goods in front of their homes. This rising informal sector activity requires support.

LAND OWNERSHIP STRUCTURE

Unlike the other islands states of the South Pacific, Tonga has no land held by indigenous people in accordance with traditional principles of land tenure, which usually provide for joint ownership by kinship groups. Instead, all land is theoretically owned by the King, who has granted out of that land hereditary estates to individual nobles, and hereditary allotments to individual commoners.

Crown Lands

According to the Constitution of Tonga and the Land Act, the Crown is owner of all the land in the Kingdom. However, the Crown is authorized to make grants of hereditary estates to nobles, and although the interest of a holder of a hereditary estate is described only as a life interest, in reality, since the nobles' estates are hereditary and not subject to forfeiture (except for insanity or upon conviction of an indictable offense), the estates of nobles are effectively removed from the control of the Crown. Accordingly, it is usual to describe Crown Lands as all those lands in the Kingdom that have not been granted to nobles. These lands constitute about one third of the total land area.

Some of the Crown Lands are set aside as Royal Estates for the ruling monarch. Certain other lands are set aside as Royal Family Estates, and life interests in such land may be granted to such persons as the monarch for the time being appoints. The Minister of Lands, with the consent of the Cabinet, is authorized to set aside such portions of Crown Lands as are required for roads, cemeteries, school sites, playgrounds, public health facilities, public ways, and commons, and for use by Government departments or for other public purposes.

The Crown, with the consent of the Privy Council, may compulsorily require any holder of land to give up possession of land that is required for public purposes, provided that compensation is paid. The Crown is prohibited by the Constitution from selling land, but land that has been set aside as Royal Estates and Royal Family Estates may be leased for projects of general public interest and benefit.

Hereditary Estates

The Constitution of Tonga provides that the King may make grants of lands to nobles, and to titular chiefs called *matapules*, and such lands are to be held as hereditary estates called *tofia*. The grants made by the Kings of Tonga before 1927 are set out in Schedule I of the Land Act enacted in 1927, and the act provides that the Crown may grant further hereditary estates to existing estate holders and to any person who is granted a title of honor. All hereditary estates must be registered by the Minister of Lands in the Register of Tofia. The rules of succession to hereditary estates are prescribed in the Constitution.

Hereditary estates are subject to allotments of land which the Minister of Lands may grant in them for commoners (see below), and holders of hereditary estates are prohibited from ejecting a person who has been allocated an allotment. Allotments to commoners must be made, if possible, out of the estate in which the commoner resides, or some other estate held by the same noble or *matapule*. Rent for allotments as prescribed by the act are to be paid without deduction to the noble or *matapule* from whose lands the allotment was made.

Hereditary estates, like all other land in Tonga, cannot be sold to anyone. They can, however, be leased with the approval

of the Cabinet, provided that sufficient land, in the opinion of the Cabinet, is retained for allotments that will be required within the term of the lease, and provided also that the leased area is not more than 5 percent of the total area of that hereditary estate. The consent of the Cabinet must be obtained for all leases for up to 99 years, and the consent of the Privy Council for leases longer than that period. Foreigners are not permitted to lease land, or to occupy land, unless the Minister of Lands has issued a permit allowing them to do so. All leases of hereditary estates are to be signed by the Minister of Lands, and countersigned by another Cabinet Member, and then registered by the Minister in a Register of Leases. Documents relating to a lease, such as assignments, grants of probate or letters of administration, mortgages, and court orders, must also be registered.

The holder of a hereditary estate may, with the approval of the Minister of Lands, grant a mortgage over such parts of the hereditary estate as have not been allocated for allotments. This is subject to the provisos that the loan secured by the mortgage is to be used for the improvement of the hereditary estate; that the mortgage is for a period not exceeding 30 years; that the mortgage is created by an assignment of lease; that the total amount of land mortgaged does not exceed 5 percent of the total hereditary estates of the holder; and that the mortgage is in favor of the Government, the Bank of Tonga, International Finance Services Ltd, or some other institution approved by the King and the Privy Council. The mortgage must be approved by the Minister of Lands, and, when approved, it must be registered by the Minister in a Register of Mortgages. Documents relating to mortgages, such as assignments, grants of probate, letters of administration, and court orders, must also be registered in a register of documents affecting mortgages. If the mortgagor defaults in repayment of the loan, the mortgagee may, after giving notice to the mortgagor and the Minister, take possession of the mortgaged land, and either occupy it, or sublease it for the unexpired period of the mortgage lease.

The registered lessee of a hereditary estate may, with the approval of the Minister of Lands, mortgage the whole or part of the lands leased to him, provided that the mortgage deed is

an assignation of lease, and the mortgage is for a period not exceeding the unexpired period of the lease. The mortgage of the lease must be registered by the Minister of Lands in the register of documents affecting leaseholds.

Allotments

Since 1882, every male Tongan reaching 16 years of age has been entitled, upon application to the Minister of Lands, to receive two allotments of land, called *apì*. One is a town allotment not exceeding 1,618 square meters; the other is a so-called tax allotment not exceeding 3.3 hectares outside any town. Alternatively, a man may apply for a single allotment of 5 hectares of agricultural (bush) land in place of the two allotments. Normally the allotments are to be allocated out of the hereditary estates of the noble or *matapule* on whose estate the appellant resides. But if there is no land available there, then the allocation may be made out of the hereditary estates of another noble or *matapule* who is willing for such allocation to be made, or if not, then out of Crown Lands. However, for several decades there has been no land available for allocation for allotments, either in hereditary estates or in the Crown Lands, so that no new allocations of allotments have been made.

Allotments are hereditary, in accordance with rules of succession that are set out in the Land Act, except that the widow of a holder has a life interest until her death, remarriage, adultery, or fornication. If no claim to succeed to a tax or town allotment has been made to the Minister of Lands within 12 months from the death of the holder, the land reverts to the estate holder or to the Crown, as the case may be.

The holder of an allotment must pay an annual rent at the rate of 40 cents per year for a five-hectare allotment, and 80 cents per year for a tax allotment. These rentals are to be paid to the hereditary estate holder or the Crown. In addition, the holder of a tax allotment is required to plant 200 coconut trees within 12 months from receiving the allotment, and to keep the trees reasonably clean and free from weeds. The holder of an allotment may be ejected from it in proceedings brought against him by the Minister of Lands in the Land Court. Grounds for eviction are

- (i) failure to keep the allotment in an average state of cultivation for the preceding three years;
- (ii) two convictions in the preceding three years for failing to plant, or to keep clean, 200 coconut trees;
- (iii) failing to pay the rent for two years;
- (iv) failing to satisfy a judgment for rent within three months of such judgment; and
- (v) entry of judgment against him on three occasions in the preceding five years for nonpayment of rent.

Town and tax allotments, like all other land in Tonga, cannot be sold to anyone. However, the holder of a town or tax allotment may, with the approval of Cabinet and subject to some provisos, grant a lease of the whole or part of the allotment for a period not exceeding 20 years. All leases must be registered by the Minister of Lands in a Register of Leases. Not more than 10 tax allotments may be leased at any one time by the same person, nor more than five town allotments, and foreigners are not permitted to occupy any land unless the Minister of Lands has issued a permit to allow this.

The holder of a town or tax allotment may, with the approval of the Minister of Lands, grant a mortgage over the whole or part of his allotment, provided that the holder is not a widow of the deceased holder, that the loan is to be used for the improvement of the allotment, that the mortgage is for a period not exceeding 30 years, and that the mortgage is created by a mortgage lease. All mortgages must be registered in a Register of Mortgages.

The registered lessee of a town or tax allotment may, with the approval of the Minister of Lands, mortgage the whole or any part of the lands leased by him, provided that the mortgage deed is an assignation of the lease, and that the mortgage is for a period not exceeding the unexpired term of the lease. The mortgage must be registered by the Minister in a register of documents affecting leaseholds.

Town allotments of not less than 1,618.7 square meters may be subdivided on application to the Minister of Lands, so as to provide allotments of not less than 752 square meters for the sons, grandsons, brothers, or nephews of the holder of the allotment. If the holder has no such family, he may surrender

part of the allotment to the Minister, who can make it available to others. Tax allotments may also be subdivided if the Cabinet is satisfied that it is possible to do so; there is no requirement that the subdivision be for the benefit of the family of the holder.

The Land Act prohibits Tongans from pledging or charging growing crops of coconut, yams, or other produce.

Disputes

One of the most frequent causes of disputes relating to allotments in recent years has been the practice of holders of tax or town allotments, to allow other people, especially family and friends, to come and occupy a part of the allotment, without any formal lease or subdivision. In time, resentments and disputes develop, and the problem becomes difficult to resolve amicably and legally, especially when, as usually happens, the occupants have built a house or a store on the part of the allotment that they were allowed to occupy.

A number of disputes have been about the entitlement of different persons to hold one allotment. Sometimes disputes have occurred because an estate holder, or his predecessor, has made promises or assurances about the same land to different people. Sometimes disputes have occurred because the office of the Minister of Lands has made errors as to the correct designation or identification of allocated land, or as to the signing and recording of the allocation.

As observed above, for many years there has been no land available for allocation to male Tongans entitled to receive land under the Constitution and the Land Act. A question must arise as to whether such an entitlement should be continued if it cannot be realized. Moreover, not every male Tongan would be able to make effective use of such an entitlement: not all male Tongans, for instance, can or want to be farmers. But the present legal provisions hold out a promise, and an expectation, of something that for decades has been unrealizable, and this gives rise to discontent. At the same time, the number of absentee holders of tax allotments is quite high, approximately 10 percent, and seems to be increasing.

In 1921, the Land Court was established to replace the Land Commission that had previously dealt with disputes

about land in Tonga. The Land Court has continued in existence to this day and consists of a judge who presides, an assessor, selected by the Judge from a panel of assessors, who assists. The decision of the court is the decision of the Judge alone; the assessor has no part in it. The judge and panel of assessors are appointed by and can be dismissed by the Privy Council. In recent years, a judge of the Supreme Court has usually been appointed as judge of the Land Court, and operates in both Courts.

Until 1990, all appeals from the Land Court had to be determined by the King and the Privy Council, but in that year, a Court of Appeal for Tonga was established. It has jurisdiction to hear appeals of decisions of the Land Court, except those relating to titles and hereditary estates of nobles, which continue to be heard by the Privy Council.

KEY CONSTRAINTS ON FINANCIAL SECTOR DEVELOPMENT

Small Size, Isolation, and Vulnerability

Tonga's economic development potential is constrained by its small size, geographical isolation and fragmentation, and vulnerability to climatic and external economic shocks. It has demonstrated the capacity to occupy market niches in agricultural production for export, but these markets are volatile. The lack of surface water precludes livestock farming except for pigs and poultry. These constraints have hindered the growth of the banking and financial sector, partly because of the high risk of funding agricultural projects.

Commercial and industrial development is limited by the small domestic market, and has not occurred in a sustainable way, despite years of promotional efforts under the Industrial Development Incentives Act. As a result, there are only a small number of bankable projects. The environment for foreign investors has been more a disabling than an enabling one: implementation of the business and development licensing legislation is discretionary, nontransparent, sluggish, and costly. The difficulties of gaining access to land and using land as collateral also constrain private investment

(see below). Basic infrastructure services—water, power, and telecommunications—also need to be improved.

Inefficient Public Sector, Ineffective Public Service

There is a general need for improvement in public sector efficiency and effectiveness in service delivery. This must encompass an improvement in public expenditure management, so that resources can be allocated more efficiently, away from meeting the relatively large civil service wage bill toward essential current expenditure. It must also involve the formulation and implementation of a plan for the reform of the large public enterprise sector. Public enterprises operate under a system of privileges, including Government subsidies and access to development assistance, which gives them unfair advantages over the private sector and seriously hinders the latter's development and, in turn, the development of a growing and healthy financial sector.

Cultural Concerns

There are conflicting views on the implications of Tongan culture and traditional practices for the practice of business. A study on entrepreneurship and business venture development by the East-West Center concluded that the extended family was not a major deterrent to business and that several family-owned and -operated companies were among the most successful indigenous businesses. However, many observers, including indigenous Tongans from all walks of life, confirm the belief that cultural, family, and religious obligations seriously affect the viability of businesses.

Dependence on foreign aid and transfers has allowed Tonga to sustain high levels of consumption and negative domestic savings, estimated at around -15 percent of GDP. Expectations that remittances would decline over time have proven incorrect. This has dampened the desire to promote measures to increase domestic savings.

No Freehold Land, Too Short Leaseholds

There is no freehold land in Tonga that can be bought and sold, so access to land by nonlandholders for businesses or investors has to be by way of a lease. This system is workable but not always easy, as there are restrictions on the length of leases (20 years for leases of tax allotments). Short leases present a real deterrent to investments involving the erection of large buildings, such as hotels. The commercial banks do work within the system using leases as collateral, but this is not always a sound security, as there are restrictions on the transfers of leases to a financial institution. Unlike land, the lease loses its value over time and therefore restricts the maturity of lending instruments.

It is unlikely that significant changes to the land tenure system will take place in the near future, so the challenge for financial institutions is how to work within the existing system. The key issue for the banking and financial system is how to utilize land to provide greater security for investors and lenders, possibly by extending the length of transferable leases.

Low Levels of Human Resources, Especially in Numeracy

Although Tonga has a high level of literacy, there is a shortage of skilled human resources, particularly those requiring numeracy and quantitative ability. A shortage of skills in the private sector has been exacerbated by the emigration of qualified people. In addition, the public service is held in high regard socially and as a career offering job security; therefore it has tended to attract the best graduates and most highly skilled workers. On the other hand, the private sector is able to attract some skilled people from the public service by offering attractive salaries. Accountants and auditors are in very short supply in the public sector for this reason.

Inefficient, Uncompetitive Financial Sector

In the financial sector itself, the small size of the market prevents the development of a more competitive banking sector. Other impediments to competition are the lack of efficient

NBFIs, the lack of a fully functioning money market, and the lack of a capital market. The extent of Government involvement in the management and lending policies of TDB has been a concern, but with restructuring under way the major constraint affecting operations is a lack of capital.

Lack of Independence, Weak Income-Earning and Supervisory Capacity at NRBT

Although NRBT has a range of central bank instruments to conduct market-based monetary control, its freedom to do so is constrained by its relative lack of independence and weak income-earning capacity. In addition to being hampered in carrying out monetary policy, NRBT's supervisory capacity has been weak. It also lacks a system to project liquidity of the financial system. There has been a need for more effective coordination between the Ministry of Finance and NRBT in order for monetary policy to become more effective.

No "Ownership" of Economic and Public Sector Reforms

A major constraint in bringing about economic and public sector reforms in Tonga has been a lack of ownership and willingness to take reform actions. Part of the problem lies in political difficulties and part in poor coordination between ministries and departments, with each acting very much on its own initiative and with its own priorities. The renewed commitment to economic and public sector reform made in 2000 provides a basis for future progress.

Subsidized Competition for Microfinance

Subsidized interest rates and grant funding have contributed to a culture of cheap lending in the microfinance sector. This has serious implications for sustainable microfinance, where interest rates need to be relatively higher than market rates of interest in view of the high risks and transaction costs. Lack of collateral is a major constraint facing women borrowers, who cannot use a town or tax allotment as security. DBT and some informal financial institutions have

accepted traditional goods such as tapa and fine mats in place of physical collateral.

RECOMMENDATIONS

There is considerable potential for private sector-led growth in Tonga. The agriculture, fisheries, and tourism sectors offer opportunities that can be financed by the commercial banks and TDB. Realization of the potential requires the maintenance of a stable macroeconomic environment and the implementation of economic and public sector reforms.

Maintain a prudent fiscal and monetary policy.

Prudent fiscal and monetary policy is a prerequisite for economic growth and financial sector development. It is especially important in Tonga because of the fragility of the external accounts. Comprehensive tax and tariff reform is expected to lead to budget restructuring and to facilitate private sector development. Civil service rightsizing is also needed to ensure fiscal sustainability and a more efficient allocation of public resources. In order to make monetary policy more effective by allowing greater use of indirect instruments, two actions are needed:²² the first is a review of the NRBT balance sheet with a view to recapitalizing the Bank; the second is the taking over of the quasi-fiscal cost of monetary policy implementation, either by an explicit budget allocation to cover the interest costs of NRBT bills, or the issue of Treasury bills by the Ministry of Finance in consultation with NRBT. The operational autonomy of NRBT also needs to be enhanced so that it can take decisive action in problem supervisory cases. This should be supported by building supervisory capacity within NRBT.

²² The suggestions are contained in the International Monetary Fund's 2001 Article IV Consultation.

Create a more conducive climate for investment.

Development and business license requirements need to be replaced by simple, clear, equitable, predictable and transparent registration systems. Specific user-friendly foreign investment legislation is needed, along the lines recommended by the Foreign Investment Advisory Service. This will also aid the development of the financial sector.

Develop a plan for public enterprise reform.

Such a plan would set a timetable for public enterprise corporatization and privatization needs to be formulated and implemented. This should build on the work already done by the Government Investment Unit set up in the Ministry of Finance in November 1999, with technical assistance from New Zealand.

Grapple with Land Tenure Issues.

A conference/workshop involving representation from Government, the private sector, NGOs, and civil society should be convened to discuss land tenure issues, especially as they affect private sector development. Specific issues that could be discussed include

- (i) amendments to the Land Act to make land more readily available, such as subdivision of allotments and cancellation of allotments of absentee holders;
- (ii) amendments to the Land Act to require decisions of the Minister as to granting of allotments and approval of leases and mortgages to be confirmed by the Land Court;
- (iii) introduction of town and country planning legislation;
- (iv) strengthening of record keeping capacity of the Ministry of Lands; and
- (v) appointment of a President of the Land Court separate from the judiciary of the Supreme Court.

Develop the Financial Sector So As To Improve Competition.

The financial sector is too small and too liquid to be fully competitive. However, some actions can be taken to reduce excess liquidity and to create more competition. These include

- (i) ensuring that NRBT is able to run an effective monetary policy, thereby building primary markets for Government and NRBT instruments;
- (ii) promoting efficient interbank markets;
- (iii) adopting a primary dealer system to facilitate market making, or if this is not feasible, considering conducting open market operations through repos and reverse repos;
- (iv) restructuring TDB;
- (v) strengthening the credit union movement as an institution; and
- (vi) making provisions for monitoring fees and charges of commercial banks.

Development of capital markets so that savers have an opportunity to invest in equity as well as deposit products is a long-term proposition. So too is the development of markets in corporate debt.

The development of a secondary market is dependent on the regular issue, by the Government or central bank, of large quantities of high-quality, fungible bonds and bills, to provide a continuous yield curve throughout the short and medium term and, over time, into the longer term. The Government and central bank must therefore take steps to make debt available.

It is recommended that Tonga continue to support the process of regional co-operation and consultation in regulatory and supervisory matters as begun by the Pacific Islands Prudential Regulation and Supervision Initiative. Related to this, a formal analysis is needed of the regulatory system and supervisory practices of Tonga for their compatibility with international accepted norms (Basle core principles), to lay the foundation for the timely harmonization of financial sector regulation and supervision on a regional basis.

It is recommended that the Government consider participation in a regional stock exchange, should the option

arise. It is also recommended that consideration be given to participation in any new regional venture capital fund.

In regard to legislative changes, it is recommended that the TDB Act be amended to ensure that the Minister of Finance cannot remove a board member for reasons other than nonperformance, ill health, or retirement, and to require greater transparency of board decisions. Provisions of the NRBT Act relating to on-site audits of financial institutions need strengthening and enforcing.

Consideration should be given to allowing the CSPF to invest part of its portfolio offshore, subject to an NRBT assessment of the implications for foreign reserves. This would allow diversification of risk and would also have the benefit of allowing some liquidity to go offshore, thereby aiding NRBT with its liquidity management. A feasibility study for the introduction of a national pension fund for all employees in Tonga has been conducted. Should a provident fund be set up in Tonga, early consideration should also be given to allowing a portion of it to be invested overseas. In addition, it is recommended that benefits from any such fund should be paid in the form of a pension, in order to ensure that a retiree has a sustained income during retirement.

Develop microfinance and integrate it with overall development strategies.

While recognizing that Tonga's small population imposes a constraint on microfinance development, a number of actions are recommended:

- (i) Undertake a microfinance awareness and education campaign, so that people and policymakers gain an understanding of the potential role it can play in the development process.
- (ii) Gather relevant data on the informal financial system, in order to establish its nature and extent, and to formulate appropriate supportive interventions. NRBT could coordinate this activity and results could be presented at a national conference aimed at laying the foundations for an action plan.

- (iii) The Government could consider establishing a revolving fund to support microfinance services. The Government could also facilitate the linkage of the informal sector with commercial banks by establishing a credit guarantee fund to help strong self-help groups to borrow money against their bank deposits.
- (iv) The Department of Co-operatives and Credit Unions should encourage self-help groups to formally become credit unions or cooperatives. Institutional capacity building for the Credit Union League is needed to ensure that it is able to provide effective supervision and advice to affiliated credit unions. This should be done within the context of a strategic plan.
- (v) The Government, with donor assistance, should create a policy and regulatory environment conducive to microfinance. This could be done through establishment of a legal framework enabling NGOs to engage in microfinance activities, and through amendment of the existing Credit Union Act to allow credit unions to charge market rates of interest.

The Government should integrate the promotion and development of microfinance into the overall development strategies of the country.