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THE ROLE AND EXPERIENCE OF DOMESTIC FINANCIAL INSTITUTIONS IN SUSTAINABLE FINANCING OF ECONOMIC GROWTH

C.S. Kimei
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THE ROLE AND EXPERIENCE OF FINANCIAL INSTITUTIONS IN FINANCING OF ECONOMIC GROWTH

By C.S. Kimei, MD - CRDB[1]

The World Bank, (1989) made a prognosis of the economies of Sub-Saharan Africa. One of its findings was:

"If Sub-Saharan Africa (S.SA) is to provide its growing population with sufficient food, productive jobs and rising incomes, its economies must grow by at least 4-5 percent a year. To do this, the region must improve productivity, increase investment and dramatically raise levels of domestic saving". And the 1996 World Development Report concluded: "Worldwide experience confirms that countries with well-developed financial systems grow faster and more consistently than those with weaker systems and are better able to adjust to economic shocks"[2].

The Tanzania financial system has not developed the capacity to effectively mobilize savings that would satisfy the demand for investment funds. The Tanzania financial system is characterized by shallowness and lack of diversity in terms of instruments and institutions. Its long history of financial repression partly explains the above. The notion of financial repression is equated with controls on interest rates, and particularly with controls which result in negative real interest rates on deposits.

[1] Views expressed in this paper are personal.

These controls are normally imposed by the government through the central bank, although they can occasionally arise from agreements between private sector financial institutions to restrict interest rates.

History of Financial repression

Immediately after the defeat of the Germans in World War I, three banks of British origin replaced German banks and formed a cartel. These came to be popularly known as "The Big Three". In 1929 the three signed an agreement that came to be known as the "Summary of Banking arrangements". The agreement required the member banks co-ordinate their activities to ensure common-interest rates, exchange rates, discriminative policy against clientele (particularly local against foreign/and a clearing arrangement. Subsequently, bank's that opened office from the 1950's were forced to conform to these arrangements if they wanted clearing house membership.

Banks' primary area of expertise is in assessing risk and pricing it. Thus under competition various financial markets and institutions evolve a structure of interest rates that is a reflection of the risks and demand/investment opportunities in the various sectors. Competition was hampered not only by the cartel's arrangements, but also by laws that restricted, or made it difficult for the indigenous people to register their own banking institutions, or have access to the foreign banks. Important among those were "The Credit to Natives Restrictions Act of 1931 and the Banking Ordinance of 1960".

The 1931 Act stipulated that the indigenous folk must go through a complicated bureaucratic procedure and receive permission from their local (mainly expatriate) government officials before they could approach banks for credit, while the 1960 Banking Ordinance set out requirements for the formation and registration of financial institutions that were almost unattainable by the indigenous population. One requirement was a minimum paid up capital of Tz.shs.2 million.

Banks concentrated their services in the export enclave and the small "modern" sector mostly in the major urban areas. While transaction and information costs of establishing pioneering services in the "traditional" sector may have entailed a prohibitively high risk premia, the sudden voluntary branch expansion by the same banks at the dawn of independence indicates that they were most probably just enjoying their oligopoly power.

Post-independence repression

At independence in 1961, Tanzania was one of the poorest countries in the world. During the first six years of independence the government relied on market forces, especially viewing foreign investment as the major instrument of industrial development.

The Foreign Investment Protection Act (Tanganyika Act No. 40) of 1963 sought to mobilize external resources for investment. Inspite of additional incentive to entice the private sector, such as industrial parks, economic survey and feasibility studies of the country's industrial potential etc the response of the private sector was muted. While banks were nationalised after the Arusha declaration in 1967, direct controls of exchange rates, interest rates and directed credits were fully implemented from 1971 within the framework of the Annual Plans, whose components were;

- The Government Revenue and Expenditure Plan;
- The Foreign Exchange Plan;
- The Annual Development Plan.

From 1971 real interest rates for savings and time deposits were negative. On average they sank from -1.4 percent in 1971 to-19 percent in 1980. On the credit side, by 1980, as pointed out in Annex I, the combined share of the public sector was 91 percent of the outstanding credit.

Domestic savings peaked at around 18 percent of GDP in 1970 but declined to less than 10 percent by mid 1980's. On the other hand by 1991 domestic savings in fixed capital formation had declined to 18 percent while foreign inflow mainly in the form of grants and concessionary lending had increased to 81 percent.

Besides fixing interest rates, credit was mainly directed to parastatals and co-operatives irrespective of their creditworthiness. Infact, need as determined politically, was the main criterion rather than creditworthiness. Apart from crowding out more creditworthy private customers, the above resulted in a growing non-performing loan portfolio. In fact the government used the financial system as an extra-budgetary channel of deficit financing through allowing the banks to enjoy various forms of accommodations from BOT. Financial institutions largely lost their ability to screen borrowers and assess risk against reward. The option of cutting off credit and collecting debts was not available. Even when credit ceilings were set intercompany arrears rose and threatened the solvency of the banks which relented and raised ceilings.

The Performance of the Financial System, 1966-98

It might be incisive to assess the performance of the financial system by analysing how it performed its twin function of mobilising financial resources and allocating them to productive investment. One important aspect in this analysis should be the structure of lending by sectors and by duration, in order to indicate the extent to which the system was effective in maturity transformation.

Resource Mobilisation:

As for financial resource mobilisation, we will use the extended money (M3)[1] to GDP ratio, which is sometimes referred to as financial deepening ratio, as well as the ratio of total bank deposits to GDP (bank intermediation ratio). Annex Table I and Chart 1 indicate the trend in these ratios from 1996-98. Chart 1, in particular, depicts that financial deepening and bank intermediation ratio in Tanzania have been two sides of the same coin .... they have followed a similar pattern, implying also that the currency ratio has been more or less constant. Both ratios rose almost consistently during 1966-1980, from about 20% (M3/GDP ratio) and 15% (bank deposits to GDP) in 1966 to 47% and 35%, respectively in 1980. The increase was recorded in the period when inflation (and the concomitant financial repression) was relatively less severe, averaging only 11.6% during 1970-79. As inflation took a high gear from 1980, the public attitude, to have taken a wait-and-see attitude, therefore maintaining their financial assets to GDP ratio constant over the period of 1980-83, following which they reduced these assets after confirming persistence of high inflation. Accordingly, the ratios declined to decade loss of about 28% (M3/GDP ratio) and 18% (deposits/GDP ratio) in 1988/89. Following a downward trend in inflation from about 1991, the financial deepening ratios started an upward trend, reaching 37% (M3 to GDP) and 27% (Deposits to GDP) in 1994/95. Despite the continued fall in the rate of inflation from 1996 (21%) to 12.1% in June 1998, financial deepening as measured by these ratios declined slightly, with M3 to GDP ratio reaching 29% in 1998, probably reflecting structural factors, such as the restructuring of the largest commercial bank (NBC), the establishment of DSE (plus floatation of TOL and TBL shares), and diversification of the financial system to include additional nine non-bank financial institutions, of which assets are not included in M3.

What do we conclude from these trends? First one should conclude that banking in Tanzania has not been quite effective in mobilising resources. Financial deepening has remained almost at stand-still: the ratio of broad monetary assets to GDP in 1998 was the same as in 1970, at 29%. Second, and really in line with theory, financial deepening has been closely and negatively relatec inflation. The authorities will go a long way in promoting t intermediation by reducing inflation.

Allocation of Loanable Funds

Annex Table 4 and Chart 2 show the allocation of bank credit public and private sectors. Annex Table 2 shows the secto allocation of overdrafts and loans by banks. It is clea demonstrated that during 1966-1989, a period of 23 years, bank lending was driven by the public sector dominance in a socia oriented economy. It would appear that inter- relationsh between financial intermediaries and the public sector we gradually broken by the conditionalities attached to the IN programmes adopted from 1986 onwards, including ceilings c government borrowing from the banking system. Thus, sinc around 1989/90, domestic credit trends have been dominated b private sectors. For example, while the ratio of private secto credit to GDP declined from 9.8% (or 72.6% of total credit) in 196(to as low as 1.7% (or 6% of total credit) in 1988, it grew to 7.2% (o 46% of total) in 1998.

Credit Productivity/Efficiency:

Related to credit allocation by sectors, is its utilisation efficiency, which can be measured by the units of credit required t produce a unit of GDP. Whereas during 1966-70, when a larger share of domestic credit was going to the private sector, the economy required an average of 13 units of credit to produce 100 units of

GDP, during 1971-85 when the public sector was absorbing an increasing share of credit, it required an average 25 units of credit per 100 units of GDP ... indicating a sharp (92%) fall in efficiency of credit usage. Following the revamping of the private sector share in total bank credit allocation in recent years, efficiency has also improved to an average of 21 units per 100 units of GDP in 1986-95 and to 15 units in 1996-98.

Credit by Sectors:

There have been dramatic changes in the allocation of credit to various economic sectors, even when we limit the analysis to the period from 1985-98. This should partly explain the movements in credit utilisation efficiency. In 1985, for example, marketing of agricultural produce absorbed 56% of total credit outstanding in the economy; while export of agricultural produce combined with trade in capital goods and other trade took 25.7% of total credit, implying that 82% of total credit went to trade related activities. Agricultural production, mining and manufacturing, building and construction, transport and tourism all combined absorbed only 16% of domestic credit. The structure has gradually changed over the period, especially after 1991. Thus as of 1998, marketing of agricultural produce had reduced its share in total credit to only 1.7%, while export of agricultural produce, trade in capital goods and all other trade maintained more or less a combined similar share of 25.6%. The combined share of agricultural production, mining and manufacturing, building and construction, transport and tourism had almost tripled to 47%.

Maturity Transformation:

One can assess the maturities of the lending portfolio of banks by assuming that overdrafts and commercial bills are short term in nature (less than a year of maturity) while loans are medium term in duration.

Table 1 Lending by Type of Facility

Year	Total Domestic Lending (Billion Shs)	% of		
		Overdrafts	Commercial Bills	Loans
1985	17.5	70.9	6.3	22.8
1990	156.9	75.8	5.2	19.0
1991	208.9	79.9	5.7	14.4
1992	199.5	77.1	6.8	16.1
1993	272.3	7.02	9.8	20.0
1994	289.9	71.1	11.5	17.4
1995	260.8	78.0	4.6	17.4
1996	147.3	78.1	5.6	16.3
1997	184.8	93.3	2.7	4.0
1998 (June)	201.4	71.9	8.8	19.3
Average		76.6	6.7	16.7

Source: BOT, Quarterly Economic Bulletins.

On average, about 17% of the principally short-term funds mobilised by commercial banks are translated into medium and long term loans. This looks like an established norm, as the ratio remained within this range over a long period, with exception of 1997 when it dropped to 4%.

> One can therefore conclude this section as follows: The financial institutions in Tanzania have performed poorly in resource mobilisation and this manifested in the financial deepening cum bank intermediation indicators that have remained more or less at the same level over the past 37 years. This abstracts from the increase in the financial ratios that was recorded during the 1970s .... this was diluted in the eighties following a high inflation scenario. (Actually, disintermediation was largely caused by persistent high inflation). Resource allocation by the banking system has also been quite inefficient ... at least until 1995: this is witnessed by the indicators of credit utilisation efficiency (in particular the credit/GDP ratio). Lastly, only about 17% of total resources mobilised by banks in Tanzania was allocated medium and long term projects. Most of the funding was given to trade-related activities.

In the next section we shall try to explore in more detail the period following the financial sector reform.

FINANCIAL SECTOR REFORM

The recommendations made by the Commission of Inquiry into the Monetary and Banking System (1990) formed the basis of the financial sector reforms. The objectives of the reforms included:

- Facilitating the attainment of macroeconomic stability;
- Supporting structural adjustments in the real economy;
- Providing effective support to the economy, especially by financial deepening and diversification in an environment of serious market competition.

Some of the structural measures that have been taken under various components of the reforms include:

i. Through the BOT Act of 1995, redefining its role and reorienting BOT. Emphasis has been placed on the conduct of monetary policy especially adopting use of indirect policy instruments, open market operations; strengthening its role in bank supervision. Training of its manpower and support of short term expert advisers should increase its capacity in the above regard. The Banking and Financial Institutions Act of 1991 streamlined banking regulations including allowing the establishment of private banks. To-date bank and non-bank financial institutions number more than 29.

ii. Restructuring parastatal banks in order to increase their managerial capacity, improve operational efficiency and rehabilitate their balance sheet by removal of non-performing assets, recapitalization and eventually privatization.

iii. Removing government controls from financial markets.

While the financial sector has been liberalised, progress on evolution of a responsive and efficient banking system has been slower. Competition has been limited by the concentration of private banks in Da'r es Salaam with upcountry expansion confined to Mwanza and Arusha. Subsidiaries of multinational banks have focused on foreign exchange deposits and trade finance lending. Although the high bank margins have been narrowing gradually, they are still very wide, indicating that financial intermediation is both limited and inefficient. The graph below illustrates the trend of the average spread.

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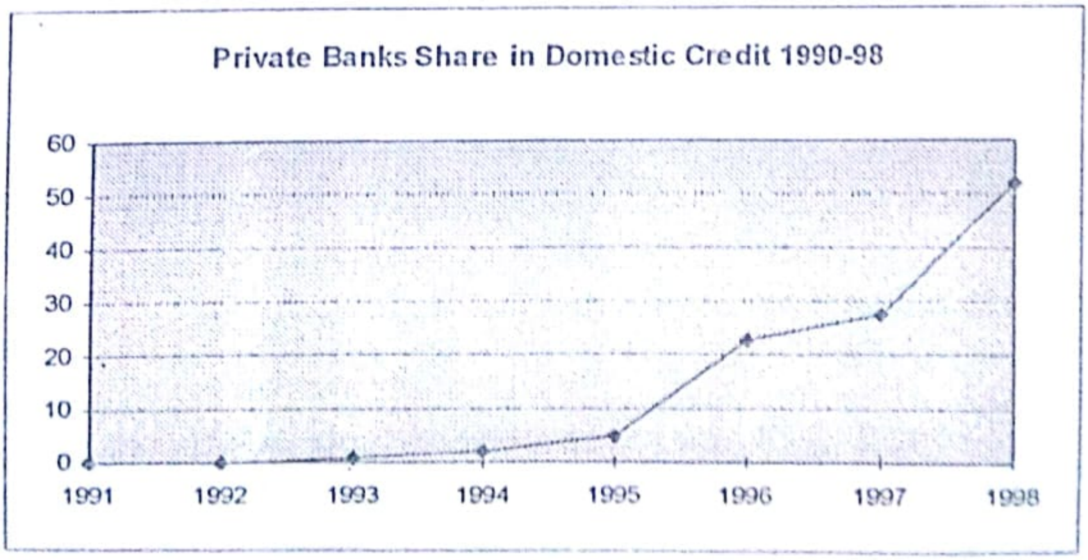


Table 2. Banks and Non-Bank Financial Institutions - Feb 98

Name	Year Licensed	Year Opened	Branch 3/25/98	[illegible] 12/3[illegible]
Banks				
1 NBC (1997) Ltd	1997 (Provisional)	N/A	34	110[illegible]
2 National Microfinance Bank Ltd	1997 (Provisional)	N/A	95	957[illegible]
3 CRDB (1996) Ltd	1996	N/A	22	55[illegible]
4 Peoples' Bank of Zanzibar Ltd	Provisional	N/A	3	24[illegible]
5 Standard Chartered Bank (T) Ltd.	1992	1993	2	9[illegible]
6 Stanbic Bank (T) Ltd	1995	1995	4	13[illegible]
7 Citibank (T) Ltd	1995	1995	2	5[illegible]
8 Eurafrican Bank (T) Ltd	1994	1995	1	4[illegible]
9 Habib African Bank Ltd	1994	1998	1	
10 Trust Bank (T) Ltd	1994	1995	2	
11 Kilimanjaro Cooperative Bank Ltd	1995	1995	1	1[illegible]
12 Diamond Trust Bank (T) Ltd	1995	1995	1	3[illegible]
13 Greenland Bank (T) Ltd	1995	1996	2	3[illegible]
14 Kenya Commercial Bank (T) Ltd	1996	1997	1	1[illegible]
15 Exim Bank (T) Ltd	1996	1997	1	35[illegible]
16 Mercantile Commercial Bank Ltd	1996	Not Operating	0	[illegible]
17 Akiba Commercial Bank Ltd	1997	1997	1	32[illegible]
18 Credit Banking Corporation Ltd	1997	Not Operating	0	[illegible]
19 International Bank of Malaysia (T) Ltd	1997	1998	1	[illegible]
20 Mufindi Community Bank Ltd	1997	Not Operating	0	0
Non Bank Financial Institutions				
1 Tanzania Postal Bank	1993	N/A	50	386
2 Tanzania Investment Bank	1994	1994	1	
3 Karadha Company Ltd	1993	1993	1	
4 1st Adili Bancorp Ltd	1994	1995	1	
5 Savings And Finance Ltd	1994	1995	1	
6 Stanbic Financial Services Ltd	1995	1995	1	
7 Crown Leasing And Finance Ltd	1996	1997	1	
8 Furaha Finance Ltd	1996	1997	1	
9 ULC (T) Ltd	1996	1996	1	
			232	3753

Source: BOT Directorate of Banking Supervision

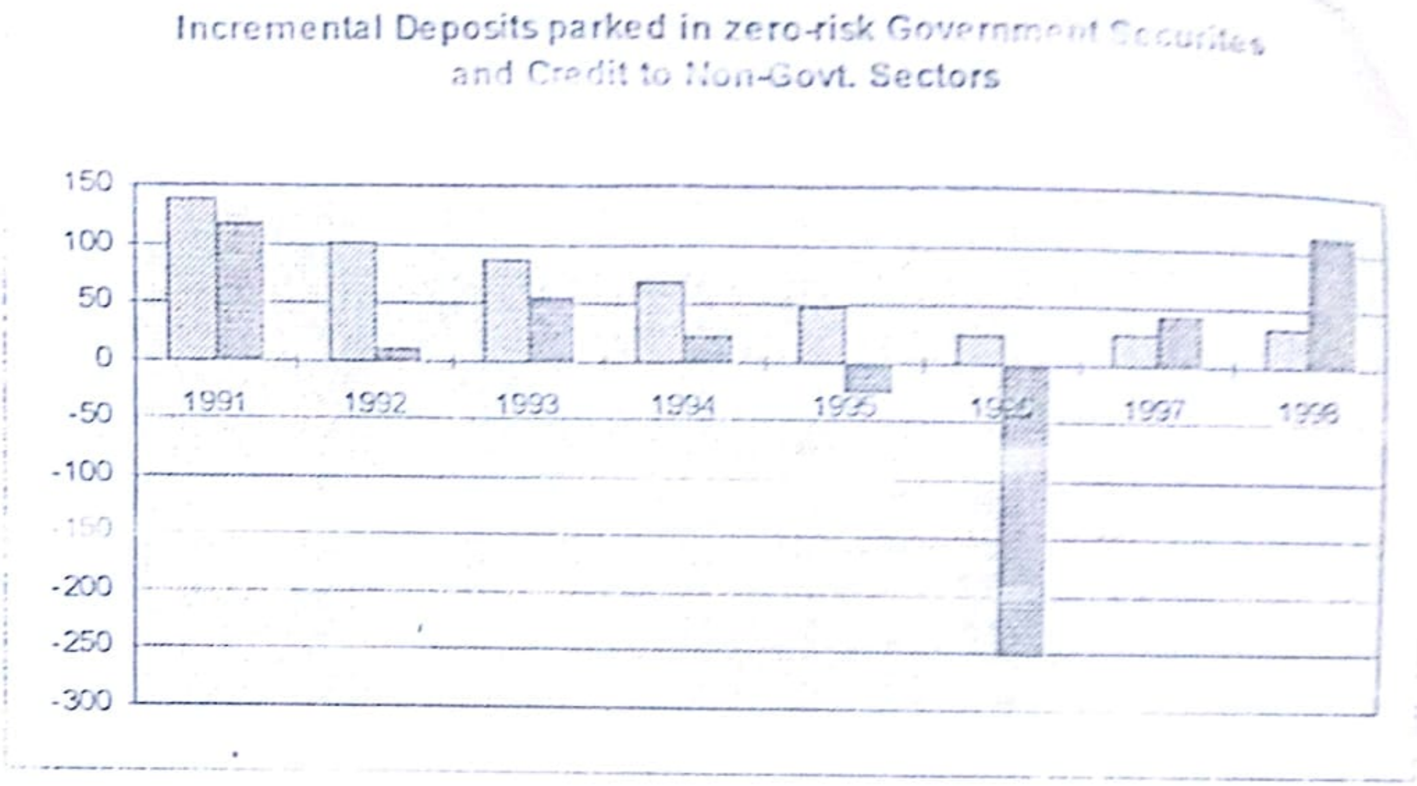
However, treasury bill yields are now an important benchmark for interest rates due to more intense competition and the increased number of financial institutions in the market. The market share of private banks in both lending and deposit mobilization rose dramatically in 1995 and is still rising. The gain in market share in both cases has been at the expense of NBC. The graphs below depicts the above trend.

Although some degree of competition now exists, it is restricted to the main markets in Dar es Salaam, Arusha and Mwanza. With the overwhelming market dominance by NBC, followed by 3 major players it is an oligopolistic market. Some of the cited impediments to more competition are:

a) Caution necessitated by the unsatisfactory contract enforcement due to court/legal system and unsupportive legislations. Commercial courts have now been established and are expected to begin operations early next year, after ongoing rehabilitation of facilities is completed. Commercial courts should go along way in reassuring financial institutions of an existence of a means of expeditiously dealing with loans that turn sour.

b) The absence of a credit history of borrowers. The financial market in Tanzania is too small for a professional credit rating agency/financial reporting agency to operate viably. It is suggested that co-operation of the major financial institutions should be able to plug this gap in the credit market.

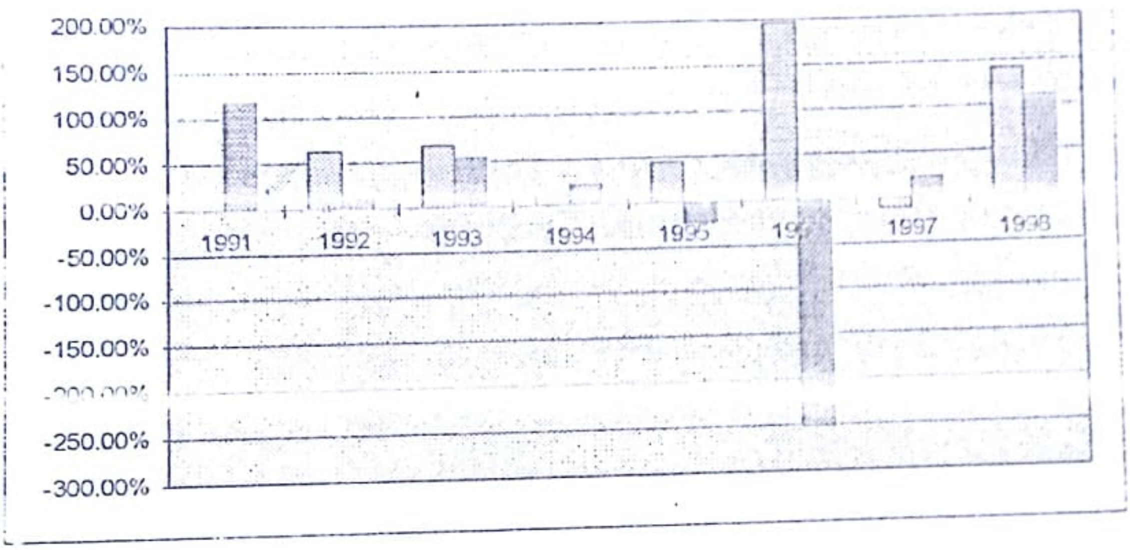
The lack of credit information has exacerbated the caution exhibited by non-indigenous financial institutions in lending. As is common in most newly liberalised financial markets in Africa a disproportional percentage of their deposits are invested in government securities and therefore denied to the private sector. The graph below illustrates this trend.



The real economy is continuing to undergo major restructuring in response to economic reforms. The inevitable time lag entailed in freeing resources from the public sector and shifting and deploying it in the private sector means that the economy has not yet generated the numbers of firms that would constitute a rapidly growing market which the financial institutions can compete for. In 1993 BOT took the precautionary measure of restricting lending by NBC and CRDB while they were undergoing restructuring. This was the major reason for the slow growth of credit. In July 1997 the BOT restrictions were lifted and this has resulted in a leap in the rate of credit growth.

The graph below shows the trend of credit growth in the period 1990 - 1998.

Credit activities picking up after a slow down



The slow inflow of Direct Foreign Investments, which tend to be mainly in the natural resources extraction, has meant the continuation of a narrow real economic base.

d) The poor infrastructure especially in the transport and communications sub-sectors is an obstacle that translates into high operating costs for financial institutions. This is an area which is receiving attention in the countries reform programme. Improvements are however expected to take time.

Responsiveness of financial institutions to the needs of households and private firms has been slow or totally lacking. Understandably it shall take time for formal financial institutions to reach out to the rural areas, meet its micro-financial needs and establish a satisfactory coverage. However the continual void of a housing finance institution since the demise of THB (Tanzania Housing Bank) is less understandable even in the present tight monetary stance. On a very small scale, leasing and hire purchase facilities are becoming available. On the other hand consumer credit and retail credit have not emerged. It is hardly convincing that the lack of the above markets is a reflection of the small size of the economy and its resource base. Structural impediments are the likely explanation of the above.

In common with other sub-saharan African countries, financial repression affected both financial deepening and the structure of the financial system. Financial intermediation was basically restricted to short-term maturities and mostly kept in the banking sector, and thereby preventing financial markets from deeping and diversifying. Although the money market is still young, it has developed sufficiently for the secondary market to be promoted. The long term end of the market remains underdeveloped. The stock exchange began operations in April this year. If stock exchange performances in SSA are an indication of the prospects of our stock exchange, then very little growth or activity is to be expected in the foreseable future. While Malaysian market capitalization is 114 percent of GDP, Kenya's capitalisation is only 5.17 percent of GDP. Kenya has one of the most developed securities_markets in SSA. It's turnover is 2.2 and only 30 of the 54 listed companies are dealt in, with the existence of only about seven "blue chips".

Contractual saving institutions in the pension system and insurance have typically structured their funds between government paper, real estate development and bank deposits.

After amendments to the charters of pensions funds, equity participation and financing are now allowed. Without the fuller development of securities markets with sufficient activity to justify intermediaries, the added function of screening investment opportunities in the capital markets may delay the fuller utilization of the funds held by this institutions. This year also saw the establishment of the National Insurance Board. At least 2 private insurance firms have been licenced. The above structural problems shall have to be overcome by them as well Venture Capital has been available for quite sometime now. It has filled a portion of the weakly developed long-term market.

The productive economic activities of the small entrepreneur and microenterprises have virtually been ignored by the financial system. Inspite of the National Microfinance Bank anticipated role in the above market and other initiatives to address this deficiency there is still no certainty that financial services aimed at this sector shall soon play the role of a catalyst in enabling this sector to play its rightful role in the economy.

FINANCIAL INSTITUTIONS AND ECONOMIC GROWTH

Both theoretical and empirical investigations have not demonstrated conclusively whether its is economic growth which lead to financial development or the reverse causality. Infact while some empirical studies have estimated that a 1 percent increase in per capital income is associated in developing countries with an approximately 1.5 percent increase in the indicators of financial depth, this does not mean one causes change in the other. As one input among an array of other inputs such as natural resources, labour markets, management technology and entrepreneurial ability, it plays a necessary but not sufficient role in economic development. Tanzania which has an economy which is lowly developed and lacks the human capital, especially in terms of a vigorous private entrepreneurial stock, the question is how given the country specifics, the financial system can play its necessary role efficiently.

Investment Growth and the Private Sector

A firm finding of the flood of research results on comparative economic growth has been "a positive, robust correlation between growth and share of investment in GDP". A close link between investment and growth in developing countries over the long run is evident in the empirical growth literature. The co-efficient of investment to GDP ratio is statistically, significant and ranges from 0.3 to 0.6, depending on various variable. (Ndulu and Ndungu 1997).

Private investment is particularly important in the growth process. The effect of the private investment ratio on growth is significantly higher than that of government investment ratio. The rate of return to private investment is 50-60% higher than equivalent government investment. While governments are uniquely qualified to invest in physical, economic and social infrastructure they are relatively poor in providing the entrepreneurial activity, risk taking and adaptability to change, that are key to sustained economic growth especially in an environment of constant technological changes.

The steady decline of aid means that long term growth can only be secured by primarily relying on domestic savings mobilization. Financial institutions are the intermediaries which not only indirectly link savers and users of funds in the economy but add further value by maturity transformation and risk transfer. Thus arrangements which permit financial claims or instruments to be traded in accordance with established rules constitute a market where financial institutions play a unique and essential economic role of mobilizing and allocating credit whereby they limit, price and trade the risk resulting from these activities. Risk is therefore inherent in the financial system and arises from many sources in the economy. The financial system needs to be sound if it is to be sustainable. In other words most of the banks and non-bank financial institutions must be solvent and likely to remain solvent in the future.

Macro-financial stability backed by a set of regulations which are administered by a regulatory body for each financial sector are essential. The regulations objectives would be to establish policies that allow only financially strong institutions to operate. The regulations would also seek to limit excessive risk taking by owners and managements of financial institutions. They would also establish appropriate accounting, valuation and reporting/disclosure rules in order to promote market discipline. Tanzania has made significant strides in meeting the above conditions.

Within the above framework, financial deepening and diversification ought to contribute substantially to economic growth. Financial deepening is said to be taking place in an economy when the accumulation of financial assets is at a faster pace than accumulation of non-financial wealth. The level of financial sector development is proxies by the level of financial deepening which is defined as the ratio of broad money (M2) to GDP.

Table: Tanzania versus Fast Growing Economies

GDP growth (15 years)	Indicator	1980	1994	1997
Tanzania 3.8%	Depth	0.43	0.27	0.31
	Bank	0.64	0.57	0.69
	Private	0.06	0.37	0.44
	Private/GDP	0.03	0.12	0.06
Average F.G.E. 6.4%	Depth	0.35	0.53	n.a.
	Bank	0.73	0.83	n.a.
	Private	0.69	0.77	n.a.
	Private/GD	0.29	0.50	n.a.

a) Depth defined as MZ/GDP, proxy for financial sector development;

b) Bank intermediation defined as the ratio of the assets of banks taking;

c) deposits over the sum of their assets plus those of the central bank, proxy for financial services available;

d) Private defined as the ratio of bank claims on the non-financial private sector to the total domestic credit;

e) private GDP defined as the ratio of claims by banks on non-financial private sector to GDP.

The above comparative table shows the shallowness of Tanzania's financial sector as opposed to the average of Fast Growing Economies in South East Asia. Two additional findings are captured by the table. First, banking activity was disproportionately smaller than in the FGE countries. Secondly, while Tanzania experienced declining savings, the FGE countries experienced double digit growth.

In developed economies financial development was demand led. Basically institutions and instruments were created to satisfy market demands. Authorities intervened ex-post mainly to change laws and regulations when major distortions or bottlenecks emerged or to effect improvements. Both the strategy and sequencing adopted by BOT in sponsoring development of the financial sector are supported by investigations in SSA. In the absence of strong market forces, which is true of our case in Tanzania, demand led development can not be expected to succeed. A pro-active strategy has therefore been adopted in Tanzania whereby the legal, regulatory and prudential framework for the money, securities and foreign exchange markets has been put in place and thereby promoting the necessary mechanism, institutions and instruments for the development of financial markets.

The sequencing of money markets where basic skills in financial market operations are acquired followed by the securities markets where the skills can be transferred is also supported by experience elsewhere in SSA.

With sufficient incentives deliberately built into the risk/reward system the above initiative should lead to financial deepening by encouraging households to hold a bigger proportion of their wealth in financial assets. It is important that an incentive framework and a business climate supportive of entrepreneurship and private sector development be in place.

Diversification

Like other SSA counties Tanzania's financial system is narrow. The principal financial instrument in the economy is bank-intermediate loans. Diversification has began with the emergence of treasury bills/bonds, equities, revival of bank acceptances, certificates of Deposits etc. Diversification of financial institutions has so far concentrated on the securities market institutions. The development of secondary money markets shall require the promotion of institutions that shall facilitate market operations.

As previously mentioned the legal, especially property rights, regulatory and contract enforcement have not been put in place in order to accelerate the development of housing finance and leasing.

MICROFINANCING

In Tanzania, Savings as well as investment have been impeded by a number of structural, institutional and economic factors. The low income of households and most economic agents coupled with the low economic development and inappropriate social capital are primary obstacles. Low economic development includes limited monetazation of the economy, large informal sectors and high transaction costs.

One hypothesis which attempts to explain determinants of savings is the life-cycle theory. It ascribes savings behavior to the population age structure and the rate of economic growth. It has however been observed that life-cycle variables link to savings are weakened by the very low income that is barely above subsistence and any growth is consumed inspite of any incentives to save. Additionally experience and cultural behaviour dictates that to smoothen income over the bad year due to weather crop/livestock infestation and bumper years savings are most useful in the form of livestock, crop stocks, other liquid assets with a ready market in the village. The intergenerational smoothing of income is thought to be influenced by the extended family which is biased towards non-financial assets.

On the other hand where financial assets are employed in saving there is a big tendency to use currency for that purpose.

a) Deficiency in the financial infrastructure is one reason. A strong financial infrastructure is characterized by appropriate legal, regulatory and prudential framework; financial strength terms of solvency and liquidity of institutions; diversity of institutional structures; adequate financial information including accounting information of uniform. and appropriate standards integrated into the financial process; the availability of relevant technologies and human skills.

b) Limited reach and coverage of financial institutions. Financial institutions are concentrated in urban areas. The NMB has a branch in almost every district. This still leaves 80 percent of households outside the reach of a financial institution. The post office has a wider reach up to the division level but administrative arrangements limit its effective reach to the district. Bank branches have a relatively high fixed cost. Low value, low volume transactions mean certain loss. Small savers find bank services too complex and intimidating. The high potential and actual fraud inhibit use of cheques. The payments and settlement system is both inefficient and slow, thus discouraging its use.

In the absence of convenient, and appropriate financial instruments and markets the best guarantee of liquidity is holding of currency. Microenterprises exclusively deal in currency, thereby further encouraging the holding of currency.

Informal and semi-formal savings and credit institutions both in the urban and rural areas rise spontaneously to serve the less affluent who have no access to formal financial institutions to satisfy their need for financial services. ROSCAs or Rotating Savings and Credit Associations which may be permanent, terminating or intermittent are very familiar in the country. They are usually based on some common bond such as workplace, residence, common worship etc. Operations management are voluntary; costs are low for transactions and information; they are convenient, flexible and participants have high confidence in the institution. Inspite of their low profile, money lenders are a feature of the rural scene. They usually assume the role by their relative affluence. Those in need of financing turn to them usually with a promise to repay the credit in terms of so many bags of agricultural produce. Those with excess cash usually deposit it with them for safekeeping.

To respond to the needs of the low income households/microenterprise there is need to drastically improve the financial infrastructure as a priority. The promotion of microfinance institutions within a framework of a minimal regulations and prudential guidance that should not in anyway stifle their growth is also crucial. There should be room for a range of microfinance institutions and arrangements for their links/transformation to more formal financial institutions as to scope and scale, instruments etc. The fear that their tendency to use currency; spatial restrictions in their operations and isolation from the wider financial system would tend to limit financial deepening is a problem that should be kept in mind when addressing their subsequent development.

A Conclusion: *Problems Inhibiting Financial Intermediation in Tanzania*

Judging from experiences in the past five years or so, financial institutions in Tanzania are still inhibited from fulfilling their rightful role of promoting economic growth by a number of factors. I shall list, but only a few of them.

Inadequate legal and structural environment:

- There are no clear and well understood standards and rules for legal procedures; and the accounting and auditing framework is still weak in ensuring adequate disclosure and timely and accurate information on operations of banks and their clientele (especially borrowers). The financial statements provided by borrowers in most cases is 'cooked' with assistance of auditors, and this undermines credit risk assessment.

- The issue of legal framework has been a subject of discussion in almost all Conferences of Financial Institutions since 1993, but little has been achieved in:

⇒ enhancing public disclosure of financial statements;

⇒ reviewing outdated laws and adopting more effective laws on corporate governance, bankruptcy procedures, contracts and private property;

⇒ improving enforcement of existing laws;

⇒ improving effectiveness of the judiciary in settlement of commercial disputes.

2) *Continued risks of sudden and frequent monetary policy and price instability:*

Sure, the central bank has been relatively responsive to the demands of the banking sector, but the persistence of high relative inflation poses a threat to confidence building in the financial sector.

3) *Instability of financial institutions and need for strengthened supervision and regulation:*

There is need to limit the adverse impact of licensing shadowy and shaky banks and financial institutions; while ensuring competition and development of innovative institutions and practices. [The playing field must also be leveled for banks and financial institutions].

4) Poor credit culture, reinforced by continued (indirect) interference of politicians in operations of the financial institutions and weak legal framework.

5) Shallowness of the securities/capital market, which hampers portfolio diversification by banks and financial institutions.

6) Lack of credit rating agencies that could reduce the costs of credit risk assessment and expand the base of potential borrowers.

7) Limited capital base of financial institutions, constraining credit extension in the light of regulatory exposure limits. This is exarcebated by little experience of banks in working with each other to allow syndication managements etc.

8) Lack of professional capacity in credit risk management, especially after the long period of directed credit activities (soft lending).

9) Discrimination against financial saving in the tax law, making other forms of savings more attractive.

10) Short maturity of deposits due to long period of persistently high inflation.

Chart 1: Financial Deepening and Economic Growth

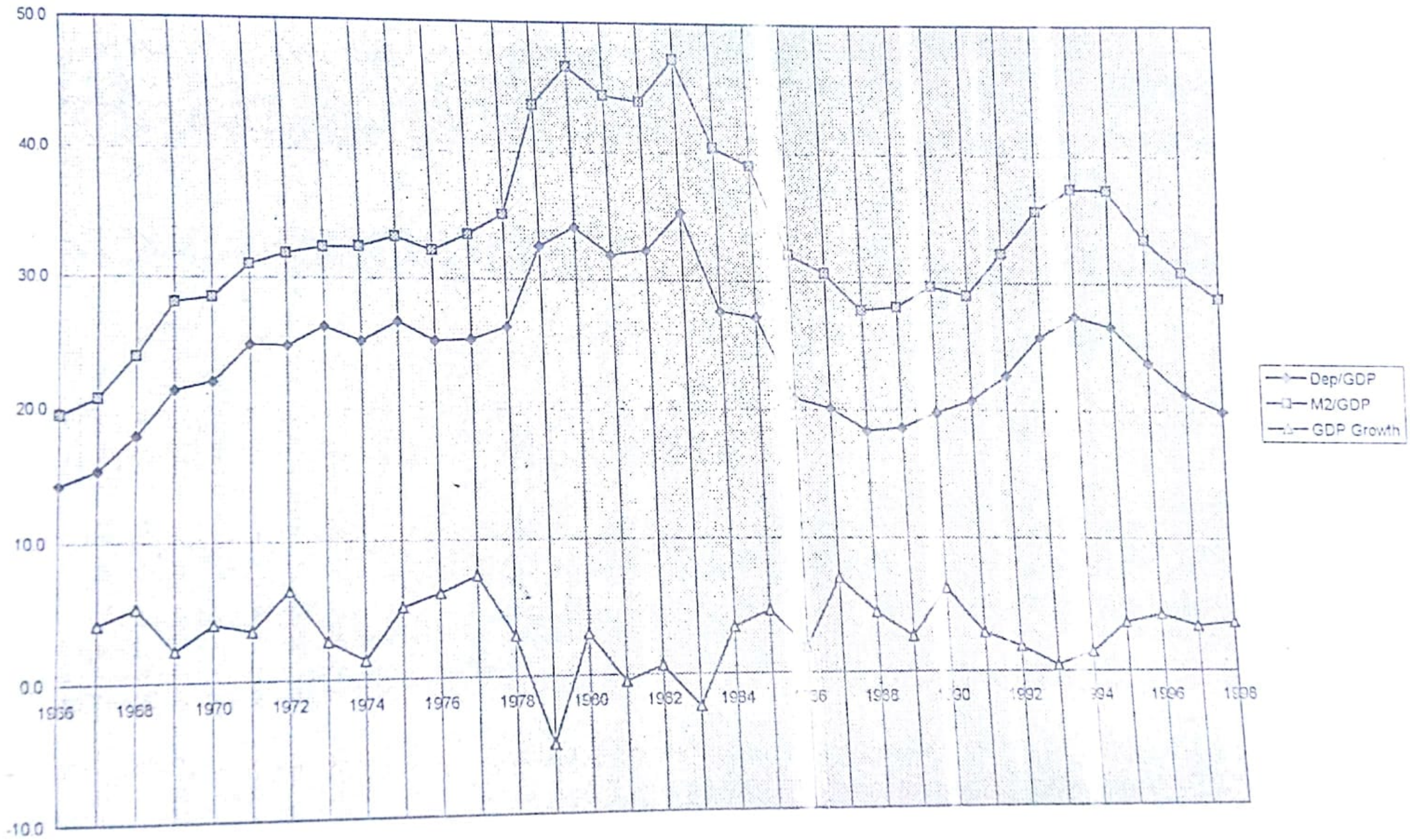


Chart 2: Allocation of Credit by Public and Private Sectors

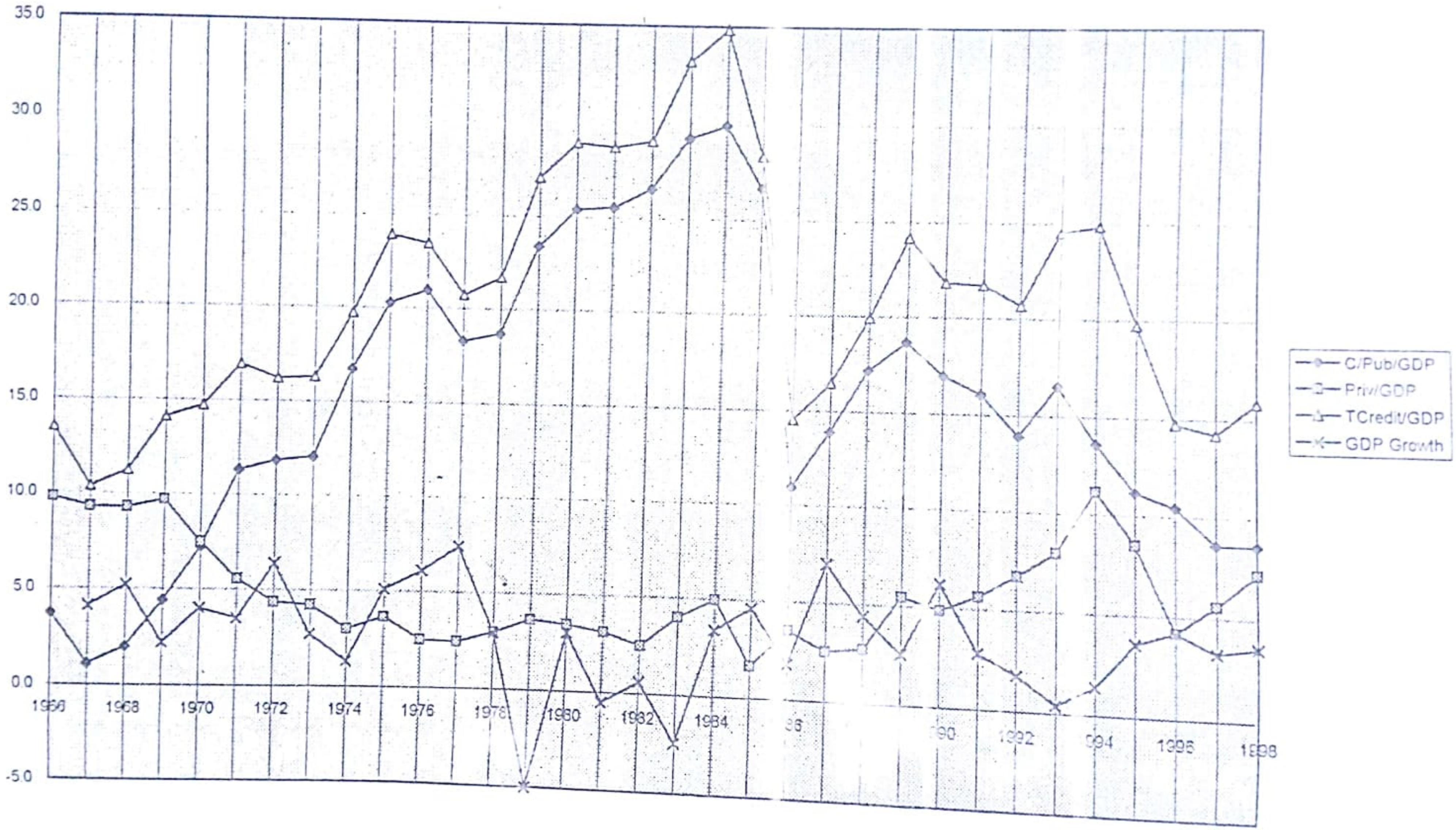


Chart 3: Private Sector Credit and GDP Growth

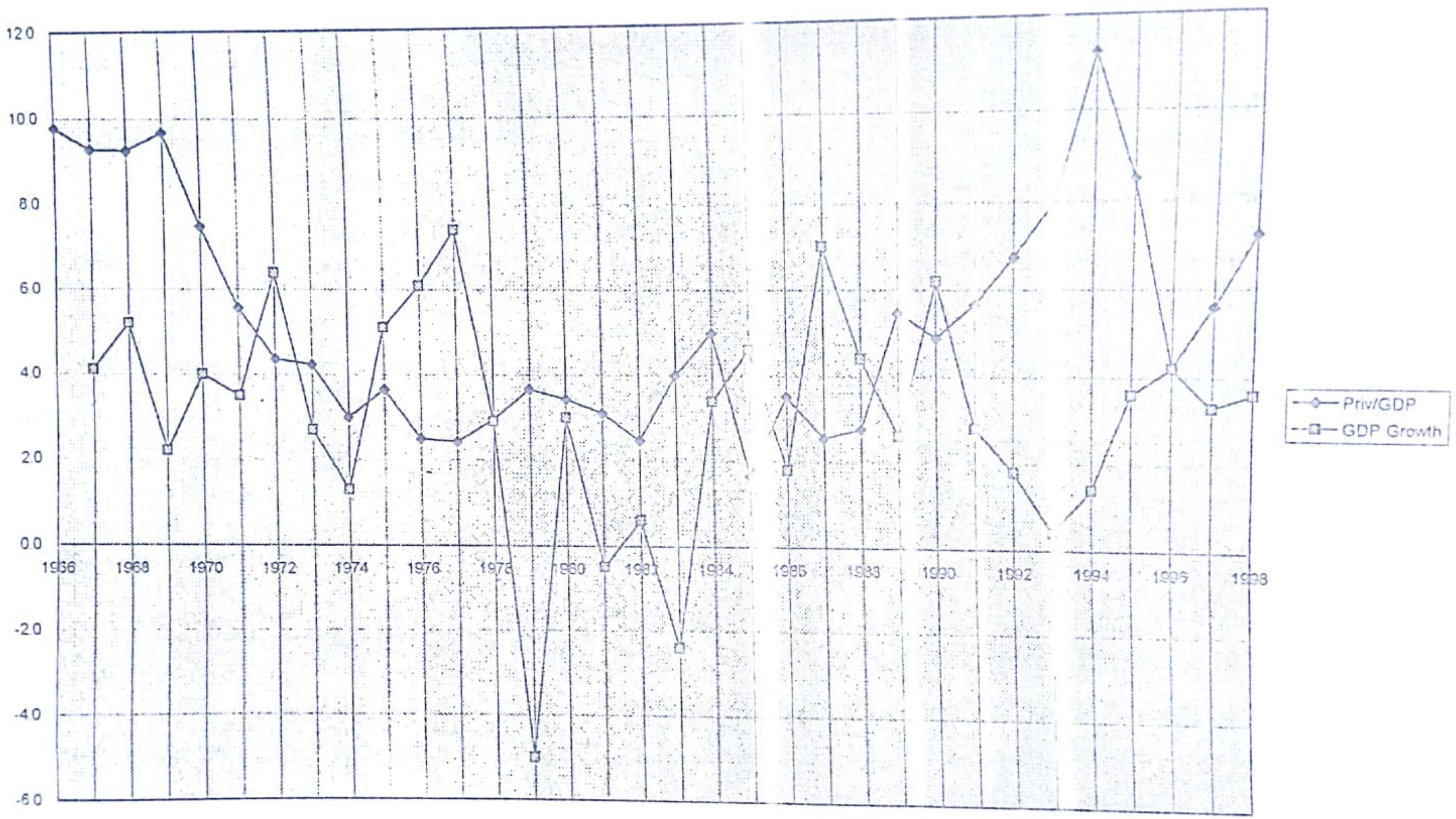
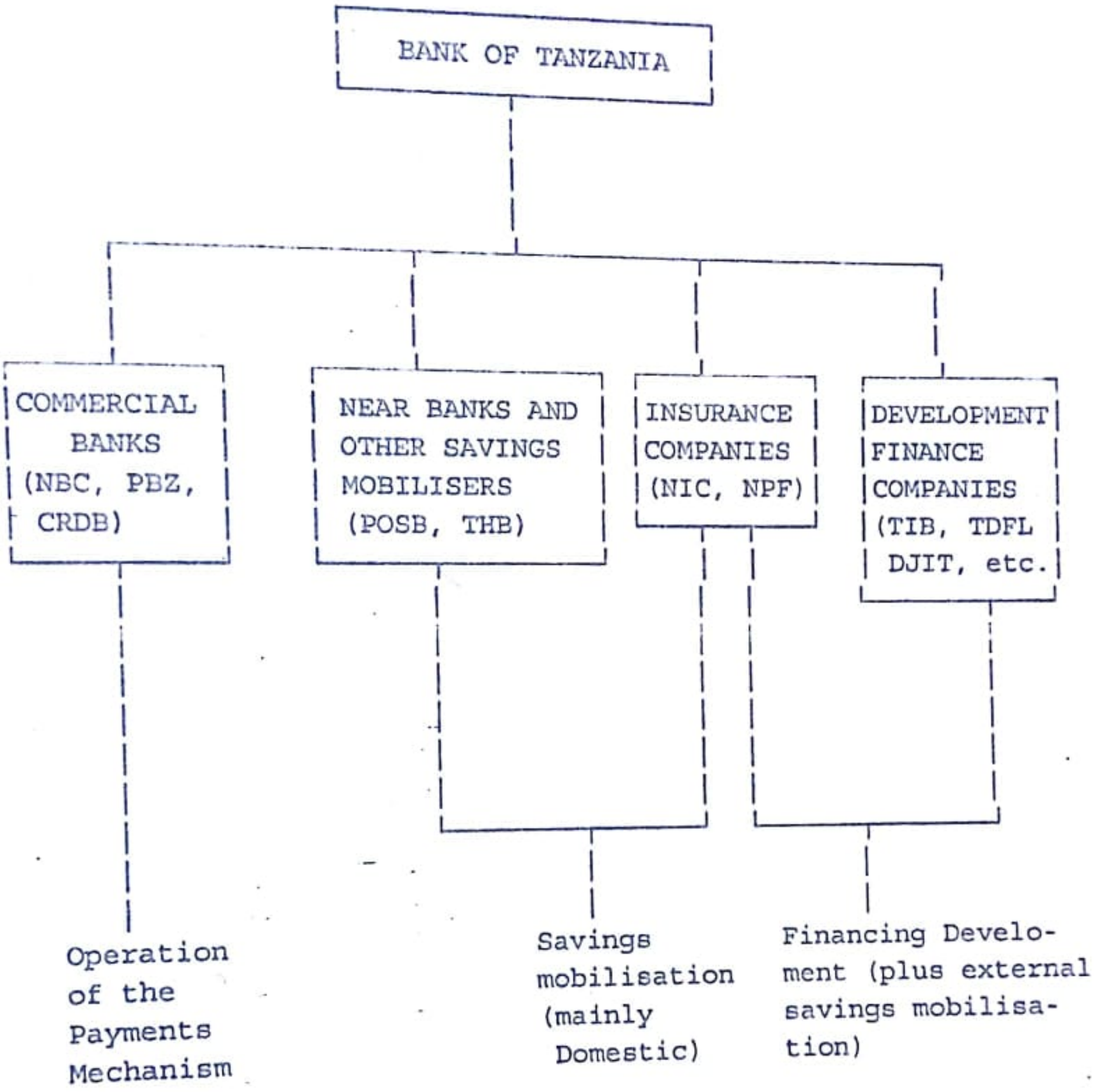


			TABLE 1									Annex 1
End of Period	Nominal GDP	Total Deposits	M/Supply(M2)	C/ Public	C/Private	Dep/GDP	2/GDP	C/Pub/GDP	Priv/GDP	T Credit/GDP	GDP Growth	Inflation
1966	6514	927	1269	242	637	14.2	19.5	3.7	9.8	13.5		
1967	6735	1033	1400	73	625	15.3	20.8	1.1	9.3	10.4	4.1	
1968	7182	1289	1719	142	665	17.9	23.9	2.0	9.3	11.2	5.2	
1969	7460	1596	2099	330	722	21.4	28.1	4.4	9.7	14.1	2.2	
1970	8215	1809	2344	593	614	22.0	28.5	7.2	7.5	14.7	4.0	2.4
1971	8857	2203	2747	1003	494	24.9	31.0	11.3	5.6	16.9	3.5	4.8
1972	10032	2489	3200	1186	437	24.8	31.9	11.8	4.4	16.2	6.4	9.1
1973	11490	3020	3720	1382	486	26.3	32.4	12.0	4.2	16.3	2.7	10.4
1974	14010	3521	4544	2341	420	25.1	32.4	16.7	3.0	19.7	1.3	18.9
1975	16988	4531	5637	3440	620	26.7	33.2	20.2	3.6	23.9	5.1	27.0
1976	22109	5567	7114	4632	550	25.2	32.2	21.0	2.5	23.4	6.1	6.3
1977	25698	6500	8592	4705	620	25.3	33.4	18.3	2.4	20.7	7.4	17.6
1978	28582	7504	10024	5345	842	26.3	35.1	18.7	2.9	21.6	2.9	7.0
1979	32317	10524	14111	7552	1182	32.6	43.7	23.4	3.7	27.0	-5.0	12.1
1980	37564	12796	17521	9542	1289	34.1	46.6	25.4	3.4	28.8	3.0	30.8
1981	46557	14868	20690	11883	1447	31.9	44.4	25.5	3.1	28.6	-0.5	25.5
1982	56247	18179	24730	14931	1385	32.3	44.0	26.5	2.5	29.0	0.6	28.9
1983	61621	21740	29127	17975	2466	35.3	47.3	29.2	4.0	33.2	-2.4	27.2
1984	74643	20591	30218	22287	3716	27.6	40.5	29.9	5.0	34.8	3.4	35.9
1985	99675	27040	38971	26537	1650	27.1	39.1	26.6	1.7	28.3	4.6	33.3
1986	157194	32774	50354	17265	5529	20.8	32.0	11.0	3.5	14.5	1.8	32.5
1987	216915	43545	66442	30116	5507	20.1	30.6	13.9	2.5	16.4	7.0	29.9
1988	323372	59334	89809	55470	8919	18.3	27.8	17.2	2.8	19.9	4.4	31.3
1989	414761	76938	116295	77465	22669	18.5	28.0	18.7	5.5	24.1	2.6	30.3
1990	561671	110994	166675	95070	27457	19.8	29.7	16.9	4.9	21.8	6.2	35.9
1991	730079	151460	211580	117158	41315	20.7	29.0	16.0	5.7	21.7	2.8	28.8
1992	935248	211908	301926	130397	63075	22.7	32.3	13.9	6.7	20.7	1.8	21.9
1993	1180230	303605	420636	194972	94125	25.7	35.6	16.5	8.0	24.5	0.4	25.2
1994	1522712	415953	569745	207393	170891	27.3	37.4	13.6	11.2	24.8	1.4	33.1
1995	2015299	535245	752910	226155	171610	26.6	37.4	11.2	8.5	19.7	3.6	23.4
1996	2451060	581357	818064	256903	103517	23.7	33.4	10.5	4.2	14.7	4.2	21.0
1997	3003382	639191	927068	258934	16830[illegible]	21.3	30.9	8.6	5.6	14.2	3.3	16.1
1998	3453889	688796	996846	296631	24955[illegible]	19.9	28.9	8.6	7.2	15.8	3.6	12.1

Figure 1

TANZANIA'S FINANCIAL SUPERSTRUCTURE



KEY:

NBC = National Bank of Commerce;
PBZ = People's Bank of Zanzibar;
CRDB = Co-operative and Rural Development Bank;
THB = Tanzania Housing Bank;
POSB = Tanganyika Post Office Savings Bank;
DJIT = Diamond Jubilee Investment Trust;
NIC = National Insurance Corporation;
NPF = National Provident Fund;
TIB = Tanzania Investment Bank;
TDFL = Tanganyika Development Finance Co.Ltd.;