Financial Sector Reforms and The Development of Financial Intermediaries in Tanzania : 1985 - 1997

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ABSTRACT: In Africa financial systems have been shackled with extensive, imprudent regulations operated on inefficient grounds and dominated by few institutions, mainly state commercial banks. Common among most of these systems have been controls on interest rates; extensive government borrowing; directed lending and restriction on domestic and foreign owned private banks. The generally restrictive financial systems are known to have hindered efficient mobilization and allocation of financial resources and impeded monetary control and policy. The introduction of financial sector reforms in Tanzania , aims at, among other things, gradually establishing more open credit markets, achieving flexible and eventually, liberal interest rates and enhancing financial intermediation.

This study analyses the impact of financial sector reforms on the development of financial intermediaries in Tanzania by comparing a list of selected indicators of financial intermediary development using data covering both the period of financial repression as well as after the introduction of the financial sector reforms. The paper attempts a time series analysis to evaluate the impact of the reforms. It also examines the correlation between the various collected indicators of financial intermediary development. The empirical results suggest that there have been some positive changes regarding the formal size of the financial system. The results also indicate that there have been insignificant changes regarding the banking system efficiency.

INTRODUCTION

Financial intermediaries, are one of the key agents to economic growth in industrialized countries, but are often insufficiently developed in developing countries and therefore they don't play the role they should in promoting economic activities. At the same time, the financial system is one of the key areas which, when handled properly is likely to bring about a positive influence on the economic development of a country. This is due to the fact that financial intermediaries, which cover a large portion of the financial system are important organs through which economic policies can be carried out.

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Financial intermediaries have an important role in the payments system of a country. Second, and possibly more important for the purpose of this article, they bring together economic agents who wish to save with those who wish to invest. These are the surplus and deficit spending units. The surplus spending units are those whose revenue exceeds their current expenditure during the period in consideration. They are savers and they dispose of their surplus funds either by acquiring capital assets or by lending them to others in one way or another or discharging previously incurred indebtedness. The deficit spending units are those whose expenditure exceeds their current revenue in a given period. They make good their deficit by borrowing or by disposing of assets previously acquired[1].

The importance of finance in the process of industrialisation is traced from the early works of Goldsmith (1955;1966;1968) and Cameron (1967;1972). These argue that, the organisation of the financial system is crucial to economic development. Gibson and Tsakalotos (1994) also argue that, the financial system can both actively help to promote growth and (in case that it is particularly poorly developed) help to stifle it. This view is based on a meticulous examination of the role of the financial system in the development of a number of now advanced countries in the late 19th and 20th centuries (Goldsmith 1955;1968 and Cameron 1967; 1972)

A quick glance at Sub-Saharan Africa shows that, the region has been facing development crisis since it gained independence over 30 years ago. In Tanzania for instance, decline in living standards; decayed infrastructure; upward trends in population growth; low real GDP growth rate; and declining per capita income are some of the factors that have qualified the country to be classified among the poorest in the world (World Bank, 1990).

The development crisis of the Sub-Saharan region assumed new dimensions in the early 1980s, partly because of the nature of the strategies which were pursued over the preceding two decades (Inanga,1997). These crises were further aggravated by macro-economic shocks and instability that precipitated financial distress, which in turn compounded problems for the financial systems (Caskey, 1992). The need for strategic policy reforms became obvious if this region (Tanzania inclusive) was to move away from the development crisis to the path of sustainable growth. One of such reforms (financial liberalisation) is the focus of this article.

AN OVERVIEW OF THE FINANCIAL SYSTEM IN TANZANIA

Government intervention in the running of the economies of Sub Saharan Africa (SSA) countries was pervasive from 1960s through the early 1980s. This intervention was essentially politically than economically motivated. In Tanzania for example, the government's socialist ideology demanded that the economy be centrally planned and that production be a state affair (Soyibo, 1997). As a result of this, government parastatals dominated the manufacturing, financial and other sectors of the economy. This government intervention in the economy bred inefficiencies and distortions and consequently resulted in misallocation of resources to the least productive sectors. Among the several ways responsible for impeding the development of SSAs' economies according to Soyibo(1997) were:

- Financial repression which reduces financial intermediation;
- Foreign exchange allocation by the state rather than the market which inhibits the allocation of scarce resources to the most productive use; and
- Heavy state and parastatal borrowings that crowded out the private sector borrowing. (p100).

[1] Goacher (1990)

The financial system in Tanzania was heavily controlled by the government thus bringing about financial repression. As a result, the financial system before the introduction of the financial sector reforms , was very narrow and highly specialised. It consisted principally of three commercial banks, the National Bank of Commerce (NBC), the Cooperative and Rural Development Bank (CRDB), and the People's Bank of Zanzibar (PBZ). Until 1991, Tanzania had only about 14 institutions in the financial system.

Prior to the liberalisation of the financial sector in Tanzania, the banking system was largely employed as an agency for public finance. Few professional bankers with the requisite banking skills were available in the system. Similarly, bank workers were also poorly paid, resulting in low work morale and low productivity. Also bank accounting standards and internal controls were weak, indicating that the central bank's regulatory and supervisory roles were inadequate.

On the other hand, Tanzania faced severe macro-economic problems characterised by balance of payments crises and sluggish output growth during the immediate years proceeding the actual beginning of the financial sector reform programme[2].

In June 1986, the economic recovery programme (ERP) was launched largely with external support. As part of ERP, a Presidential Commission of Inquiry was set to study the entire financial system. A report to this effect was published in July 1990. As a result of this report, a comprehensive reform of the financial sector was introduced aimed at stimulating the financial system to operate on commercial lines after serving for long, almost entirely as an arm of the budget department of the government.

The reforms included restructuring the existing formal financial institutions by writing off a portion of their non - performing assets, plus an appropriate provisioning of the remaining loans and recapitalisation; restructure the policy environment in which existing financial institutions were operating; encourage the establishment of the domestic and foreign owned private banks, including joint ventures with Tanzanian interests ; and introduce/strengthen the provisioning for the Bank of Tanzania's prudential, regulatory and supervisory roles in the financial system.

Meanwhile, in 1986 the Bank of Tanzania (BOT) also started using indirect monetary policy instruments, including more active use of discount policy, open market sales of certificates of deposit, and auction of treasury bills. At the same time, existing banks were required to undertake managerial and operational restructuring, including rationalisation of staff and branch networks, streamlining operations, and strengthening internal control systems (Bagachwa, 1994).

This paper attempts to undertake a performance evaluation of the reforms introduced in the early 1990s and analyse their impact on financial intermediaries development. It is organised as follows; the first part has an introduction. The next section provides an overview of the

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[2] Soyibo (1997)

financial system in Tanzania. Section four covers the methodology used, data analysis and a discussion of the empirical results. Section five concludes the discussion.

METHODOLOGY

INDICATORS OF FINANCIAL INTERMEDIARIES DEVELOPMENT

The following indicators of financial intermediaries development were earmarked to be used in the study.

These include the size:
a) of the financial system.
b) and efficiency of the banking system.
c) of non bank private financial institutions.
d) of private insurance institutions.
e) of the private pension funds.

Financial System Size
On the basis of work by King and Levine (1993), three measures of financial system development were used. These are :

a) The ratio of liquid liabilities of the financial intermediaries to GDP which measures the overall size of the formal financial system. It is obtained by taking money supply (M_3) divided by GDP[3]. It is assumed that the size of the financial system is positively related to the provision of financial services, in which case, if the assumption holds, then this ratio should be a good indicator of the provision of financial intermediaries services. The ratio is obtained as follows:

$$r = M_3/GDP \quad \text{............} \quad (1)$$

where:
r = ratio of liquid liabilities to gross domestic product.
M_3 = extended broad money.
GDP = gross domestic product.

b) The ratio of quasi-liquid liabilities to GDP and it is obtained by taking money supply (M_2) minus narrow money (M_1) divided by GDP.[4] By subtracting the narrow money from the broad money, this measure focuses on longer-term liabilities. However liquid and quasi- liquid liabilities that finance government deficits may not reflect the provision of efficient financial intermediary services. This ratio is obtained as follows:

$$rq = M_2 - M_1 / GDP \quad \text{...........} \quad (2)$$

where:
rq = ratio of quasi-liquid liabilities to gross domestic product.
M_2 = broad money.
M_1 = narrow money.
GDP = gross domestic product.

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[3] M_3 refers to the extended broad money and GDP is Gross Domestic Product

[4] M_2 refers to broad money while M_1 refers to narrow money

c) The ratio of domestic credit to private firms to GDP. This ratio is obtained by taking domestic credit to the private sector divided by GDP. i.e:

rdc = dc/GDP .... (3)

where:

rdc = ratio of domestic credit to private firms, to gross domestic product.

dc = domestic credit to the private sector.

GDP = gross domestic product.

Size of the Banking System

In order to measure the level of development of the banking system, a ratio of the total banks' deposits to GDP was used. A measure of banking efficiency, which is called spread, that equals the difference between bank lending and borrowing rates was calculated. However, this measure may not accurately capture banking efficiency because the interest rate data may not accurately reflect borrowing and lending costs. Normally the spread indicator does not provide accurate information on how well banks monitor firm managers, and also fails to capture government intervention in the banking system in an informative way (Dermirguc - Kunt and Levine, 1996).

Despite the above limitation on this indicator, it is still widely used for completeness. The level of development is determined as follows:

bd = tbd/GDP .... (4)

where:

bd = ratio of total banks' deposits to gross domestic product.

tbd = total banks' deposits.

GDP = gross domestic product.

Banking efficiency is determined as follows:

S = blr - bdr .... (5)

where:

S = spread.

blr = banking lending rate.

bdr = banking deposit rate.

Non Banks Financial Intermediaries

The level of development of non-bank financial intermediaries is measured by using the ratio of assets of private non - bank financial intermediaries to GDP. This ratio is obtained by taking assets of these intermediaries and divided by GDP.

rbf = apn/GDP .... (6)

where:

rbf = ratio of assets of private non-banking financial institutions to gross domestic product.

apn = assets of private non-bank financial institutions.

GDP = gross domestic product.

Insurance and Pension Companies

The level of development of private insurance and pension funds is assessed using the ratio of assets of private insurance companies and pension funds to GDP and it measures the size of these intermediaries. This level is determined as shown in equation (7)

rpp = app/GDP .... (7)

where:

rpp = ratio of assets of private insurance companies and pension funds to gross domestic product.

app = assets of private insurance companies and pension funds.

GDP = gross domestic product.

Using the above seven listed equations, various indicators of financial intermediaries development were computed and the results are discussed below.

Discussion of the Results

The results from the study indicate that there have been some positive changes regarding the financial system recorded over the study period that is from a ratio of 0.040 to 0.636 for liquid liabilities to GDP and 0.014 to 0.183 for quasi-liquid liabilities to GDP.[5] However, for Domestic credit to private sector to GDP, the increase recorded has not all been smooth throughout the study period. This is also indicated in Table 2 where between 1994 and 1996 there was a drastic fall of the ratio from 0.00153 to 0.00059. This ratio started increasing again in 1997. The non-smoothness behaviour could be explained by the increase in the spread ratio during the same period since these ratios are negatively correlated (the correlation coefficient is approximately -0.01).[6] This increase could have deterred away borrowers.

On the total bank deposits to GDP ratio, the results show that there has been an increase of this ratio during the period between 1985 to 1994 and then it started declining up to 1997. This again could be attributed to the increase in the spread during the same period and as a result it could have discouraged savers.

For the level of development of non-bank financial intermediaries, it was not possible to make any useful analysis due to the lack of statistics about the assets of private non-bank financial institutions except for 1996 and 1997. Similarly, it was not possible to assess the development of private insurance and pension funds due to the fact that the reform policies regarding this sector have just been implemented and todate only a few private insurance companies have been granted license to start business, while no single private pension scheme is in operation.

Correlation Co-efficients Between Various Indicators of Financial Intermediary Development

The correlation coefficients between the various indicators of financial intermediary development were computed in order to examine their relationships. The three measures of the size of the financial system , i.e. the liquid, quasi-liquid and the domestic credit to the private sector ratios are all positively correlated although not all the co-efficients are stronger. The only highly correlated indicators are the liquid liabilities and quasi-liquid liabilities with a correlation co-efficient of 0.99. The other two indicators have correlation co-efficients between o.35 and 0.38 .

[5] Table 2.

[6] Table 1.

The correlation between the indicators of the size of the financial system and the indicators of the size of banks are again all positive except for the one between spread and domestic credit to the private sector, which is -0.01.

This further explains the pattern of both the domestic credit to the private sector to GDP and the spread ratios between 1994 and 1997 as shown in Table 2. For the rest of the correlation co-efficients though are positive, they are not as strong except for that of quasi-liquid liabilities to GDP and spread and that of liquid liabilities to GDP and spread which are 0.84 and 0.86 respectively.

Table1: *Correlation Coefficients Between the Various Indicators of Financial Intermediary Development*

Lgdp to qgdp	Lgdp to dgdp	Lgdp to tgdp	Lgdp to sp	qgdp to dgdp	qgdp to tgdp	qgdp to sp	dgdp to tgdp	dgdp to sp	tgdp to sp
0.99	0.35	0.38	0.86	0.35	0.35	0.84	0.41	-0.01	0.42

Notes:

where:

Lgdp	=	Liquid liabilities to GDP
qgdp	=	quasi - liquid liabilities to GDP
dgdp	=	domestic credit to private sector to GDP
tgdp	=	total banks deposits to GDP
sp	=	spread

(The above coefficients have been computed using the ratios of various indicators of financial intermediary development in Table 2 below)

Table 2: *Some Indicators of Financial Intermediary Development, in Tanzania 1985 - 1997*

YEAR	Liquid liabilities to GDP	Quasi - Liquid liabilities to GDP	Domestic Credit to Private Sector to GDP	Total Banks' Deposits to GDP	Spread	Assets of Private Non Bank Financial Intermediaries to GDP
1985	0.040	0.014	0.00028	0.0034	1.88	na
1986	0.050	0.014	0.00026	0.0029	1.89	na
1987	0.062	0.018	0.00037	0.0027	-2.11	na
1988	0.080	0.021	0.00072	0.0027	-1.34	na
1989	0.101	0.028	0.00085	0.0026	-1.92	na
1990	0.140	0.043	0.00112	0.0026	-1.80	na
1991	0.170	0.056	0.00097	0.0027	-1.93	na
1992	0.240	0.078	0.00115	0.0031	-2.46	na
1993	0.330	0.094	0.00157	0.0035	2.79	na
1994	0.438	0.121	0.00153	0.0036	6.2	na
1995	0.560	0.138	0.00105	0.0034	9.63	na
1996	0.584	0.168	0.00059	0.0030	15.7	0.0434
1997	0.636	0.183	0.00068	0.0028	9.27	0.0611

Source: see table i - vi

Notes:
na - not available.
spread is defined as the difference between borrowing and lending rates

CONCLUSION

The financial sector reforms which were initiated during the early 1990s appear to have changed the direction and the manner in which banks and non - banks financial institutions used to serve their customers. A general outlook indicates that , the entry of new banks and non - bank financial institutions has enhanced competition thus resulting in improvement of the quality of financial services and products offered.[7] This view is, to a certain extent, supported by the ratios obtained on the financial system size.

[7]. See Bank of Tanzania (BOT) Economic and Operations Report for the year ended 30th June, 1997.

In addition to the enhanced competition, there has also been an increase in the menu of the financial services offered coupled with a gradual withdrawal of the Government from the ownership of banks and financial institutions. However, despite all the above indications of success, there are still a lot of issues which need to be addressed by the Government in order for the financial sector to function properly in the process of intermediation. These issues include :

a) The need to attain macro-economic stability with the narrow definition of this concept i.e. attaining and maintaining low and stable inflation. It is strongly believed that the foundation stone for a sustained high-quality and broad-based economic progress is everywhere derived and guaranteed if the value of the country's currency is stable.[8] A high and variable inflation is disastrous to economic growth. It discourages savings, because savers become uncertain about the future value of their money. Investors , too, cannot make long-term investment decisions, because of uncertainties about their future profits. High inflation leads to high interest rates, which culminates again in lower investment. It also exacerbates income inequalities, as those with fixed incomes such as workers and pensioners lose.

   The Bank of Tanzania in its attempt to achieve this stability, set a target of attaining a single digit (5 percent) level of inflation by end-June, 1998. To date this level has not yet been achieved although the rate has been lowered.

b) As a result of the financial sector reforms, the introduction of new financial products has been an ever-increasing complexity in the banking business and financial innovations thus posing an increased degree of risk in financial dealings.

   Similarly, to date the use of cheques as a means of settlement commands little confidence from the public. On the other hand, records indicate that prior to the introduction of these reforms, the few state banks that existed accumulated huge non-performing assets. This was partly due to poor execution of loans by bank staff and also due to the existence of a non-supportive legal framework in assisting to recover the non-performing assets.

   In order for the financial sector to function properly in the mobilisation and allocation of resources, changes in our legal set up are essential. These include modernisation of the laws governing the use of (or rather misuse) of cheques and court injunctions, modernisation of the bill of exchange act, setting up of commercial courts and improving the administration of justice. This is likely to help the resolution of commercial disputes and the enforcement of contracts. Similarly, the modernisation of the bill of exchange act has to take into account the ever-increasing degree of risk as a result of financial

[8] Rashidi (1997)

innovations in order to safeguard the financial system.

c) Nearly 90 percent of the Tanzanian population depends on agriculture and small-scale production. However, the present formal banking institutions have not addressed the financial needs of the rural and small scale enterprises. There is a need, therefore, for establishing a financial system which will cater for needs of the rural and micro-enterprises whose operations have been adversely affected by the closure of commercial bank branches operating in rural areas.

   In doing so, direct and indirect support may be needed from a number of players , including the Government to provide the enabling environment; the Bank of Tanzania to institute appropriate standards for micro-finance operations in the country and providing the regulatory and supervisory framework; and the commercial banks, financial institutions and NGOs to develop innovative methods for reaching the majority of Tanzanians, while maintaining their profitability.

d) The private sector in Tanzania is still considered to be relatively weak. There is a need, therefore, to speed up the parastatal sector reforms, particularly the privatisation of the remaining giant public institutions (i.e. Tanzania Harbours Authority, Tanesco, Tanzania Railways Corporation, NBC and NMB). This is expected to result into a strong, efficient and dynamic private sector (a good example is the privatisation of the Tanzania Breweries Limited and Tanzania Cigarette Company) as opposed to the existence of inefficient public institutions. This is expected to lead into a significant viable client base for the financial system.

e) There is also an urgent need of opening up the management of pension fund schemes by putting in place the legal framework that will regulate entry and supervise private pension scheme funds. This is expected to increase competition and hopefully reduce inefficiency exhibited by the two state pension schemes (PPF and NPF). This inefficiency has led, in some cases, the two schemes investing in wrong investments as well as failing to compensate the contributors with a realistic rate of return on their contributions.

   Finally, an advise to the monetary authorities in the country, is that, apart from trying to attain macro-economic stability they should also consider devising a policy environment that will facilitate sustainability of the reforms. This is because both policy sustainability and macro-economic stability are fundamentally linked to private investors' perception of government credibility. Nevertheless, despite the presence of some few areas which have not recorded significant success, there appears an indication of a promising future in terms of achieving successful overall financial sector reforms in Tanzania.

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Table i: *Tanzania: Interest Rate Structure (1985 - 1997)*

Year	Ifr	Midr	Mdr	Adr*	RD**	Milr	Malr	ALR*	RL**
1985	33.1	5.0	14.0	9.5	-17.7	8.0	16.0	12.0	-15.9
1986	32.4	5.0	14.0	9.5	-17.3	8.0	16.0	12.0	-15.4
1987	30.0	14.5	27.0	20.75	-7.12	7.0	29.0	18.0	-9.23
1988	31.2	14.5	27.0	20.75	-7.96	9.0	29.0	19.0	-9.30
1989	30.4	16.0	29.0	22.5	-6.06	9.0	31.0	20.0	-7.98
1990	35.9	16.0	29.0	22.5	-9.90	9.0	31.0	20.0	-11.7
1991	28.8	16.0	29.0	22.5	-4.90	9.0	31.0	20.0	-6.83
1992	21.9	16.0	30.0	23.0	0.90	9.0	31.0	20.0	-1.56
1993	25.2	16.0	25.0	20.5	-3.75	9.0	39.0	24.0	-0.96
1994	33.1	16.0	30.5	23.25	-7.40	24.0	39.0	31.5	-1.20
1995	28.4	13.0	35.0	24.0	-3.43	27.7	45.0	36.35	6.2
1996	21.0	2.0	34.0	18.0	-2.48	28.0	46.0	37.0	13.22
1997	16.1	2.5	29.0	15.75	-0.31	21.0	32.0	26.5	8.96

Source: Bank of Tanzania (BOT) : Economic Bulletin, Various Issues.

Notes:

Midr	minimum deposit rates
Ifr	inflation rate
Mdr	maximum deposit rates
Adr	average deposit rates
RD	real average deposit rates
Milr	minimum lending rates
Malr	maximum lending rates
ALR	average lending rates
RL	real average lending rate
*	average rates are obtained from the two rates i.e. minimum and maximum rates .
**	rates obtained by adjusting the nominal average rates for inflation as follows: $1+r = (1+i)/(1+p)$

where:

r= real Interest Rate

I= nominal Interest Rate

p= inflation Rate

Table ii: *Tanzania: Monetary Survey (1985 - 1997)* ***Millions Tzs***

YEAR	M_3	M_2	M_1	QQL(M_2-M_1)
1985	38971	38946	25270	137676
1986	50353	50235	35810	14425
1987	66495	66137	47131	19006
1988	89809	89339	65401	23938
1989	116295	114807	82419	32388
1990	166669	163153	111085	52068
1991	211579	205818	135926	69892
1992	301926	284968	185876	99092
1993	420636	367095	247091	120004
1994	569743	486489	329625	156864
1995	752912	613695	428285	185410
1996	818063	684991	449213	235778
1997	927069	760353	493869	266484

Source: Bank of Tanzania (BOT) : Economic Bulletin, Various Issues.

Notes:
M_3 - extended broad money, M_2 - broad money
M_1 - narrow money. QQL - quasi - liquid liabilities (M_2 - M_1)

Table iii : ***Domestic Credit to Private Firms Millions Tzs***

YEAR	PSL* (Nominal)	DEFLATOR	PSL* (Real)
1985	2404	8.6	279.53
1986	2935	11.4	257.46
1987	5848	14.8	395.14
1988	15779	19.5	809.18
1989	24713	25.4	972.95
1990	47141	34.5	1366.41
1991	54117	44.4	1218.85
1992	79696	54.1	1473.12
1993	136565	67.8	2014.23
1994	178921	90.2	1983.60
1995	163515	115.8	1412.05
1996	116556	140.1	831.95
1997	162300	162.6	998.15

Source: Bank of Tanzania (BOT) : Economic Bulletin, various issues
* private sector lending

Table iv: *Total Claims of Deposit Money Banks (1985 - 1997) Millions Tzs*

YEAR	TBD* (Nominal)	DEFLATOR	TBD* (Real)
1985	28613	8.6	3327
1986	32828	11.4	2880
1987	43545	14.8	2942
1988	59333	19.5	3043
1989	76938	25.4	3029
1990	110940	34.5	3216
1991	151460	44.4	3411
1992	211907	54.1	3917
1993	303605	67.8	4478
1994	415952	90.2	4611
1995	535700	115.8	4626
1996	582284	140.1	4156
1997	668490	162.6	4111

Source: Bank of Tanzania (BOT) : Economic Bulletin, Various Issues
* total bank deposits
The national consumer price indices (NCPIs) have been used as deflators for the entire study period.

Table v: Tanzania GDP 1985 - 1997 (by kind of economic activity) Millions Tzs

YEAR	GDPfc*(current prices)	GDPfc*(constant 1992 prices)
1985	166304	983221
1986	224464	1001349
1987	302681	1071539
1988	468100	1119016
1989	582166	1147746
1990	760005	1219137
1991	989594	1253132
1992	1275917	1275915
1993	1607763	1281007
1994	2125325	1298945
1995	2796642	1345246
1996	3452558	1401711
1997	3832341	1457381

Source: Bank of Tanzania (BOT): Economic Bulletin, various issues.

* GDP at factor cost

Table vi: Total Assets for Private non Bank Financial Institutions 1985-1997 Millions Tzs

YEAR	ASSETS
1985	na
1986	na
1987	na
1988	na
1989	na
1990	na
1991	na
1992	na
1993	na
1994	na
1995	na
1996	60815
1997	89059

Source: annual report for 1997 , Directorate of Bank Supervision, Bank of Tanzania.

Note:
na - not available.