FINANCIAL LIBERALISATION AND ITS IMPLICATIONS FOR POVERTY REDUCTION IN TANZANIA

By Dr. Ali A. Kilindo

Abstract

In Tanzania the allocation of savings towards economically deserving investment projects has moved from a highly centralized government system to a liberalized system. While in the earlier system savings generated through say, postal banks, social security systems and business profits were creamed off by high taxes and foreign savings were submitted to the government which then decided where funds would go, the new system, a multiple of banks both general and specialized, a security market, investment banks, etc compete for the available resources through interest rates, dividends etc. The cost of capital is market-determined and premied for each enterprise is set on the basis of the market's best judgment of relative risk. Since no lender wants to make losses, projects that cannot pay the market cost of capital would be screened out of the market. In this article it is observed that the desire of banks is to lend "to completely safe borrowers whose reputation is known or whose collateral is relatively risk-less" or to borrowers with whom the bank has special connections. With the current set-up, private banks are likely to keep credit to the agricultural sector to a minimum. Lack of credit can be a constraint to expanding small farmer agricultural output and a good many of existing public and private credit institutions lend rather little to small farmers. This is likely to impede economic growth and hence poverty reduction. To attain economic growth and poverty reduction, a deregulated but well supervised financial sector needs to be developed. It is recommended in this paper that financial liberalization should be accompanied by deregulation and supervision mechanisms that ensure the poor receive the badly needed credit.

Introduction

Combating poverty has been a standing resolve of the government of Tanzania since independence, despite the fact that widespread poverty remains the main challenge of development (URT 2000). Preliminary results of the 2000/01 Household Budget Survey (HBS) indicate that in year 2000, 52.8 per cent of the population live in households surviving below the Basic Needs Poverty line, with 31.5 per cent below the Food Poverty line. This situation shows a worsening or unchanged situation compared to ten years ago where the HBS of 1991/92 revealed values of 48.8 and 28.3 per cent respectively. The government has long recognised that the performance of the economy has to improve substantially in order to combat poverty.

In recognition of the crucial role a stable macroeconomic environment plays in the performance of the economy the government of Tanzania formulated several policies to bring stability. These efforts were spelt out in the Structural Adjustment
Programme (SAP), of 1982/83-1984/85, followed by the First Economic Recovery Programme (ERP1), 1986/87-1988/89. ERP had more concrete steps spelt out to bring about macroeconomic stability. These included liberalisation of prices, raising interest rates and adjustment of the exchange rate. The government has also designed a number of strategies and policies in order to reduce poverty as articulated in Vision 2025; the National Poverty Reduction Strategy (NPES) and The Poverty, Reduction Strategy Paper developed in the context of the HPIC initiative.

To address financial sector issues, a Presidential Commission was set up to investigate matters in the Banking and Financial Sector. Following the Commission's report in 1990, a financial sector reform was initiated in 1991. This consisted of several measures, including restructuring the existing formal financial institutions (FFIs) and the policy environment in which they operate; encouraging the establishment of domestic and foreign owned private banks including joint ventures with Tanzanian interests; and introducing and strengthening adequate provision of the central bank's prudential regulatory and supervisory roles of the financial system.

The purpose of this paper is to highlight and discuss several emerging issues related to financial liberalisation in the context of poverty reduction. The question is whether the new emerging financial sector regime provides an adequate framework for achieving increased savings and investment. The second objective is to analyse the implications of the regime on credit flows to the agricultural sector, where the most poor are. The paper also draws from other studies to propose some alternatives to designing financial liberalisation that is desirable for poverty reduction.

Liberalisation of the financial sector is not interpreted in the pure "classical" sense of the withdrawal of the government from the financial market. The working definition involves the re-definition of the roles and responsibilities of the principal institutions like the Central Bank and the other financial institutions and a re-regulatory rather than de-regulatory regime. In such an approach the emphasis is then on the understanding on the part of policy-makers of the micro-level and institutional milieu within which financial change occurs and the effects of this liberalisation on the setting of macroeconomic policy, in particular, monetary policy.

The paper is organised in five sections. After this short introduction, section two gives a brief discussion of developments of the financial sector. This is followed by a theoretical exposition of the link between financial development and poverty in section three, and section four discusses how financial liberalisation can contribute to poverty reduction. The last section concludes and outlines some policy implications.
EVOLUTION AND PERFORMANCE OF THE FINANCIAL SECTOR

Evolution
Before restriction to entry was eliminated the financial sector in Tanzania was monopolistic with a narrow organized financial system comprising of only twelve financial institutions apart from the Central Bank. The National Bank of Commerce accounted for over 95 per cent of the deposits in official financial institutions. There were only five long-term financing institutions and two statutory savings institutions. All institutions in existence with the exception of two, a long term financing and a savings one that were private, were owned by the government and enjoyed monopoly power. Private entry and the diversification of the financial assets menu was restricted by the legislation of the state monopolies.

During the pre reform period monetary policy was characterized by the fixing of interest rates and pre- determining the quantity and price of credit through the Finance and Credit Plan. The atmosphere that would bring competition was thus non-existent.

Other macroeconomic policy related indicators revealed high inflation rate, exchange rate controls and expansionary monetary and fiscal policies which persisted up to the mid-eighties.

The report of the Presidential Commission gave way to a comprehensive financial sector reform in 1991. The major objectives spelt out in the reform document are, among others, the creation of an enabling environment for the evolution of a competitive and efficient financial system. The main elements of the implementation include restructuring of existing institutions; allowing entry of new ones and creation of an enabling environment and prudential regulatory roles of the Central Bank.

Liberalization has resulted in the mushrooming of banks and non-bank financial institutions. At present there are seventeen commercial banks, eleven non-bank financial institutions, eleven insurance companies, two pension funds and one stock exchange all operating in the country. It is well documented that the inefficiency features of the pre- reform error are still in existence. Commercial banking is still near monopoly in nature, deposit rates are still low while lending rates are high; the payments system is still poor, characterised by high transaction costs.
### Table 1: Pre and post-reform financial institutions in Tanzanian

<table>
<thead>
<tr>
<th>Type of Institution</th>
<th>Pre-reform</th>
<th>Post-reform</th>
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</thead>
<tbody>
<tr>
<td><strong>Commercial Banking</strong></td>
<td>1. The National Bank of Commerce (NBC)</td>
<td>1. National Bank of Commerce;</td>
</tr>
<tr>
<td></td>
<td>2. The People's Bank of Zanzibar (PBZ)</td>
<td>2. People's Bank of Zanzibar;</td>
</tr>
<tr>
<td></td>
<td>3. The Tanzania Rural Development Bank (TRDB)</td>
<td>3. The Cooperative and Rural Development Bank (CRDB);</td>
</tr>
<tr>
<td><strong>Savings Institutions</strong></td>
<td>1. Post Office Savings Bank (POSB)</td>
<td>1. Diamond Jubilee Investment Trust;</td>
</tr>
<tr>
<td></td>
<td>2. Diamond Jubilee Investment Trust (DJIT)</td>
<td>2. The Postal Bank of Tanzania;</td>
</tr>
<tr>
<td><strong>Insurance Companies</strong></td>
<td>1. National Insurance Corporation (NIC)</td>
<td>3. Savings and Finance;</td>
</tr>
<tr>
<td></td>
<td>2. Zanzibar Insurance Corporation (ZIC)</td>
<td>4. Mufindi Community Bank;</td>
</tr>
<tr>
<td><strong>Contractual Savings Institutions</strong></td>
<td>1. The National Provident Fund (NPF)</td>
<td>5. Kilimanjaro Cooperative Bank;</td>
</tr>
<tr>
<td></td>
<td>2. The Parastatal Pensions Fund (PPF)</td>
<td>6. Diamond Trust Bank</td>
</tr>
</tbody>
</table>

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| Long Term Financing | 1. Tanzania Investment Bank (TIB) | 2. Karadha Company  
|                     | 2. Tanganyika Development Finance Co Ltd (TDFL) | 3. Stanbic Financial Services  
|                     | 2. Tanzania Housing Bank (THB) | 4. ULC Tanzania Ltd.  
|                     | 5. Furaha Finance Company | 5. Furaha Finance Company  

Source: Bank of Tanzania

Performance
There are a number of measures of financial development. The use of one measure or the other is dictated by the availability of data. In most cases the indicators used are the ratio of M2 to Gross Domestic Product (GDP). In some cases financial savings as a ratio of M2 is used to get the proportion of M2 that is in the form of savings deposits. Table 2.2 displays the indices for Tanzania. There is an erratic trend in some indicators of financial development in nominal terms, for most of the period prior to 1990. The post 1992 period is characterized by a decline. Note that this represents the post liberalization period. The ratios are well below those attained in most industrialized countries (60 to 70 per cent), and close to 100 per cent in Japan in the late 1960s (Polak, 1989).

There has been a sharp decline in liquidity in the economy as evident from the sharp decline in the ratio of M2 to output, pointing to the process of demonetization. A major source of this relative liquidity contraction appears to be the slow credit expansion to the private sector relative to the extent of retirement of Government debt and scaling back the size of the public sector, releasing resources through the banking system. This liquidity is parked in the banking system, where low loan-to-deposit ratios are prevalent. With lending by NBC (1997) and NMB frozen under a Memorandum of Understanding with the Treasury, except for holding Treasury Bills, excess liquidity in the banking system has risen at a time when the private sector is starved of credit. This is the process of disintermediation. Since returns to Treasury Bills have fallen from the giddy heights prior to 1995 (from an excess of 45 per cent to the current range of 8-15 per cent), commercial banks are hard pressed to look for more profitable outlets, having squeezed savings deposit rates as far down as possible to reduce the cost of funds. There is thus likely to be a strong emission of liquidity into the economy as lending activities pick up.
Table 2 Tanzania; Financial and Economic Performance Indicators

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</thead>
<tbody>
<tr>
<td>Real GDP Growth</td>
<td>4.4</td>
<td>2.2</td>
<td>2.9</td>
<td>3.3</td>
<td>3.1</td>
<td>5.1</td>
<td></td>
</tr>
<tr>
<td>Annual Change in M2</td>
<td>15.4</td>
<td>19.2</td>
<td>21.2</td>
<td>23.1</td>
<td>29.1</td>
<td>20.7</td>
<td>12.5</td>
</tr>
<tr>
<td>Income Velocity (GDP/M2)</td>
<td>4.1</td>
<td>3.2</td>
<td>2.4</td>
<td>2.2</td>
<td>4.7</td>
<td>5.6</td>
<td>6.6</td>
</tr>
<tr>
<td>Financial Development (M2/GDP)</td>
<td>0.24</td>
<td>0.2</td>
<td>0.41</td>
<td>0.3</td>
<td>0.21</td>
<td>0.2</td>
<td>0.15</td>
</tr>
<tr>
<td>Inflation rate (annual change i NCPI)</td>
<td>3.7</td>
<td>26.3</td>
<td>30.3</td>
<td>33.1</td>
<td>19.7</td>
<td>26.9</td>
<td>5.5</td>
</tr>
<tr>
<td>Real Deposit Rate (per cent)</td>
<td>-0.2</td>
<td>-25.4</td>
<td>-25.4</td>
<td>-23.1</td>
<td>-9.8</td>
<td>-1.4</td>
<td>2.7</td>
</tr>
<tr>
<td>Budget Deficit/GDP (per cent)</td>
<td>7.8</td>
<td>16.8</td>
<td>13.6</td>
<td>8.1</td>
<td>2.1</td>
<td>-4.6</td>
<td>1.6</td>
</tr>
</tbody>
</table>

Source: Computed From Bank of Tanzania Economic and Operations Report (various)

In terms of efficiency there has not been much achievement though. There still exists near monopoly in commercial banking by the former largest commercial banks, the interest rate spread is large and bank commissions are exorbitantly high. The payments and settlements system is still poor.

There has however been significant success in combating inflation from a high 30 per cent during most of the 1980s to a single digit level by the beginning of 1999. This has been achieved through monetary policy whereby the Central Bank has followed the “tight” money supply rule for the second half of the 1990s. It is believed that the real sector, the private sector in particular has been the hardest hit by monetary stringency. This then implies increased efforts to monitor what is happening in the real sector in terms of production and distribution.

A more precise measure of the functioning of the financial system uses four indicators, King and Levine (1993). First, is the size of intermediaries defined as liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of banks and non-bank financial intermediaries on a proportion of GDP). Second, is the degree to which the central bank versus commercial banks are allocating credit to the sum of bank credit and bank domestic assets. Third, credit allocation to the private sector as measured by the ratio of credit allocated to private enterprises to total domestic credit (excluding credit to banks). Fourth, credit to private enterprises as a ratio of GDP. Table 3 compares these ratios obtaining in Tanzania with those of very rich, rich, poor and very poor countries. It is indicative that Tanzania ranks as poor in terms of financial development.
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The performance of credit growth, particularly to the productive sector has not been impressive after liberalization.

Table 3: Comparative Financial Development Indicators

<table>
<thead>
<tr>
<th></th>
<th>Very Rich</th>
<th>Rich</th>
<th>Poor</th>
<th>Very Poor</th>
<th>Tanzania</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEPTH</td>
<td>.67</td>
<td>.51</td>
<td>.39</td>
<td>.51</td>
<td>.35</td>
</tr>
<tr>
<td>BANK</td>
<td>.91</td>
<td>.73</td>
<td>.57</td>
<td>.58</td>
<td>.52</td>
</tr>
<tr>
<td>PRIVATE</td>
<td>.71</td>
<td>.58</td>
<td>.47</td>
<td>.51</td>
<td>.35</td>
</tr>
<tr>
<td>PRIVY</td>
<td>.53</td>
<td>.31</td>
<td>.20</td>
<td>.13</td>
<td>.16</td>
</tr>
</tbody>
</table>

Source: King and Levin (1993), Bank of Tanzania (2000)

Very Rich: Real GDP per Capita >US$4998
Rich: Real GDP Per Capita >US$1161 and < US$4998
Poor: Real GDP per Capita > US$391 and < US$1161
Very Poor: Real GDP per Capita <US$391

DEPTH = Liquid Liabilities to GDP
BANK = Deposit money bank domestic credit divided by deposit money bank + central bank domestic credit
PRIVATE = credit on the non-financial private sector to domestic credit
PRIVY = gross claims on private sector to GDP

Lending to deposit ratio declined consistently from 141.4 per cent in 1990 to 50.6 per cent in 1995 and to a low 33.8 per cent in 1998. Commercial banks also manifested increasing risk aversion in lending giving preference to holding government paper. This partly reflects high risks in lending, difficulties to assess the credit worth of private borrowers and problems associated with the handling of commercial disputes. Thus initiatives by the bank of Tanzania to establish the credit information bureaux and commercial courts are critical in this respect.
Sector Allocation of Credit

The rural sector is deprived of financial services and agriculture has for a long period been getting below 10 per cent of domestic lending with marketing of agricultural produce experiencing the steepest decline in the share of credit (Table 4). Banks are concentrated in major urban centres and closure of remote branches of the National Bank of Commerce has left the gap of financial services to rural areas unfilled. This demands a deliberate strategy to intensify micro-finance services and pursue new initiatives for availing such services.

In view of the increasing role assigned to the productive sector, it is expected that more credit should have been directed to this sector. The actual outcome given in Table 2.3 does not support that. Although there seems to be a shift of credit towards the private sector proportion wise the financial sector is still the main recipient.

Table 4 Agriculture’s share of Bank Credit (Bill TSHS and per cent)

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</thead>
<tbody>
<tr>
<td>Total Lending</td>
<td>156.9</td>
<td>208.9</td>
<td>215.4</td>
<td>272.2</td>
<td>271.3</td>
<td>260.8</td>
<td>147.3</td>
<td>184.8</td>
<td>251.1</td>
<td>312.0</td>
<td>340.6</td>
</tr>
<tr>
<td>Agricultural Production</td>
<td>13.2</td>
<td>20.0</td>
<td>16.6</td>
<td>17.9</td>
<td>24.4</td>
<td>21.1</td>
<td>17.3</td>
<td>13.9</td>
<td>18.8</td>
<td>17.7</td>
<td>21.4</td>
</tr>
<tr>
<td>per cent</td>
<td>8.4</td>
<td>9.6</td>
<td>7.7</td>
<td>6.5</td>
<td>8.9</td>
<td>8.0</td>
<td>11.7</td>
<td>7.5</td>
<td>7.2</td>
<td>5.7</td>
<td>6.2</td>
</tr>
<tr>
<td>Marketing of Agriculture Produce</td>
<td>49.2</td>
<td>76.5</td>
<td>52.9</td>
<td>68.4</td>
<td>73.0</td>
<td>51.2</td>
<td>8.8</td>
<td>2.6</td>
<td>6.4</td>
<td>2.4</td>
<td>1.3</td>
</tr>
<tr>
<td>per cent</td>
<td>31.3</td>
<td>36.8</td>
<td>24.6</td>
<td>25.1</td>
<td>26.9</td>
<td>19.6</td>
<td>5.9</td>
<td>1.4</td>
<td>2.5</td>
<td>0.7</td>
<td>0.3</td>
</tr>
</tbody>
</table>

Source: Bank of Tanzania: Quarterly Economic Bulletins, Various
The marketing of agricultural produce had also its share of credit reduced from 31.3 per cent in 1990 to a low 5.9 per cent by 1996, falling further to 0.3 per cent by 2000. The agricultural sector has the majority of the population engaged in smallholder agriculture. Deprivation of credit to these activities is certainly a handicap to the struggle against poverty.

Figure 2 Lending to Agriculture (per cent of domestic lending)

FINANCIAL STRUCTURE AND POVERTY: THE LINK

Financial and Economic Development
Preoccupation of development economics on financial issues started way back in the mid sixties. Cameron et al. (1967) and Goldsmith (1969) showed that as a country attains economic development its financial system also grows. Quantitative indicators were designed to measure the extent of financial development. These include the Financial Interrelations Ratio which is the ratio of the value of all financial assets to the value of all tangible assets, and the Financial Intermediation Ratio measured by the value of assets of financial institutions as a proportion of the value of all financial assets. The two measures would require data that are usually not easily available. Simpler measures are therefore used to measure the level of financial development. The most commonly used indicators are the number of bank offices per head of population or total bank assets as a percentage of national income, and narrowly defined or broadly defined money (M2 or M3)\(^2\), as a percentage of GDP. Economic literature indicates that at the early stages of economic development the financial superstructure grows faster than the economy (Goldsmith, 1969; Jansen, 1989a). It has also been observed that the level of the indicators of financial development and their change over time may differ between countries, the source of the difference being the rates of growth and economic structure. Again observed in the studies is that financial development starts with the banking system and gradually diversifies into non-bank financial institutions.
Jansen (1989b) brought into the literature four types of financial structures which are interpreted as stylised phases of financial development, distinguishing them as the currency board; a structure with a Central Bank and commercial bank; a structure in which there is financialisation of savings and a fully developed financial system with great diversity of financial institutions and open links to international capital markets. The last stage is characterised by a labour force which, according to Jansen (1989b), is proletarianised; and the main forms of household savings are pension funds and life insurance contributions. These savings are channelled to the corporate and public sector by financial institutions. It is in the corporate sector that productive investment is undertaken.

As Jansen (1989) points out, the line of analysis above introduced the role of financial development on economic development as opposed to earlier literature. Kalecki (1962) is said to have assigned no role to financial development and Polack (1957) assumed that money was mainly used in transactions and intermediation between savers and investors. Jansen (op.cit.) links such approaches to the second phase of financial development. The shift of the structure to the third type lead the focus of analysis to the determinants of the demand for broad money balances by for example Shaw, (1973); McKinnon, (1973); Taylor, (1983) and Fitz-Gerald, (1988).

According to the discussion most developing countries would be in transition between the second and third phase of financial development with few in the third phase. In such economies monetary and financial aspects of development deal with situations where savings are to a considerable extent of financial development, with the most form of savings being time and savings deposits of commercial banks. This situation is due to the absence of active stock markets and where they exist they are at a rudimentary stage. Another fact is that the formal financial sector exists side by side with the informal financial sector.

While most of the above analogy is observable in most developing countries, the issue that is not clear is whether the phases were acquired by the same forces both in developed and developing economies. The development to the last stage, for example, may have been brought about by the inter-linkages in the world economy due to failure of domestic structures to mobilise savings internally. What is common in most developing countries is poor performance of the financial sector which is now held as one of the causes of economic decline. The common prescription to the ailment of the economies is removal of financial repression as manifested by negative real deposit and lending rates, interest rate and credit ceilings, directed credit and high reserve requirements as spelt out in financial sector reforms.
Financial Reforms: Selected Experiences

Financial sector reforms are usually based on the analyses of McKinnon (1973) and Shaw (1973). According to these two studies the financially depressed economies would be characterised by low or negative lending and deposit rates, and ceilings on the rates. In addition, credit would be directed to priority areas and there would be ceilings set. This would bring negative growth impact and hence renewed growth can be attained through removal of all manifestations of financial repression. For the policies to bring about the desired results, price stabilisation through macroeconomic and institutional policies is required. The basis of the argument is that the real economy’s performance is affected by distortions as interest rate ceilings and credit subsidy in the financial sector.

A review of the impact of financial liberalisation policies in developing economies is treated in Soyibo (1994), revealing some records of mixed success but most often dismal outcomes in many reforming countries. It is also suggested that the failure of the reforms are due to absence of a credible and sustained policy environment. Lack of success has also been explained by the narrow approach to financial liberalisation, pointing to the need for financial liberalisation to be broadly interpreted beyond the banking system and reform to include the entire financial system, with non-bank financial and capital markets.

Soyibo (1994) indicates that the most common feature in reforming countries has been the inability of domestic savings to support investments. This has been accounted for by the respective credit policies that have been influenced by the desire to achieve narrow macroeconomic targets. It has been suggested that where this is happening, it is desirable to have a broader context of macroeconomic reform which seeks a balance between the maintenance of macroeconomic performance such as inflation and the balance of payments and the growth of total domestic credit.

Tanzania is among the reforming economies that have not recorded desirable performance in terms of domestic resource mobilisation. This is despite financial sector reforms advocating the objective of financial deepening and increased savings mobilisation. At the same time the Central Bank has been conducting a tight monetary policy to achieve the objective of price stability. This casts doubts on the possibility of striking a balance between the twin objectives by the existing form of financial liberalisation. It is our belief that a broader approach is required.

Financial Liberalisation and the Poor

Financial liberalization usually brings into the liberalizing country many foreign banks. Many of the Commercial Banks are merely overseas branches of major private banking institutions in developed countries. Their orientation therefore like that of multinational corporations, may be more toward external and less toward internal monetary situations. The commercial banking system is likely to restrict
its activities almost exclusively to rationing scarce loanable funds to "credit-worth" medium and large-scale enterprises in the modern manufacturing sector. Small farmers and indigenous small-scale entrepreneurs and traders in the manufacturing and service sectors must normally seek finance elsewhere - sometimes from family members and relatives, but more typically from local money lenders and loan sharks who charge exorbitant rates of interest.

Prior to reforms, development bank loans were concentrated to a few large borrowers. Coupled with the existence of high inflation, growing budget deficits and negative real interest rates this led to a serious "credit crunch" during most of the 1980s. With real interest rates on savings deposits in a negative quadrant and expectations of continued inflation and exchange rate devaluation contributing to capital flight, it is not surprising that few individuals were willing to save. Commercial banks naturally tended to ration the available credit because they were subject to numerous lending restrictions and faced mandatory interest rate ceilings on loanable funds at levels well below market-clearing rates.

The suggested solution to the problem is to liberalize the financial sector by allowing nominal interest rates to rise to market clearing levels. This would cause real interest rates to rise to positive levels and thus remove the explicit interest-rate subsidy accorded to preferred borrowers who are powerful enough to gain access to the rationed credit. Higher real interest rates should also generate more domestic savings and investment and permit some borrowers to shift from the unorganised to the organized credit market. The World Bank cites evidence from a number of countries such as Thailand, Turkey, and Kenya, where the liberalization of interest rates generated more savings and investment. On the other hand, evidence of the effects of financial reform in Chile during the 1970s revealed many shortcomings of the process (Todaro, 1989). These included the acquisition of numerous banks by large conglomerates or 'grupos' who used their new financial resources to buy privatised firms or to expand their own companies. When many of their firms faced financial losses, these 'grupos' had to resort to additional funding to avoid bankruptcy.

Reform and liberalization of the organized money sector is, therefore no panacea for the financial systems of developing nations. While removing artificial interest-rate distortions and thus possibly promoting more savings and more efficient investment allocation, financial reform always needs to be accompanied by other more direct measures to give small farmers and investors access to needed credit and by careful governmental supervision of the banking and financial sectors to prevent undue concentration by local elites, (Nyagetera and Kilindo, 1995). Therefore, "getting prices right" is only one step, albeit an important one, in making development better serve the needs of the poor majority. Financial liberalisation affects the poor in that it may or may not enable them to acquire new technology, create markets that supply additional inputs and absorb additional output, institutions willing to lend to small farmers on terms the farmers consider
attractive, and most important farmers willingness to borrow, to invest and repay loans.

FINANCIAL LIBERALISATION AND THE TANZANIAN POOR

The emerging trend
A desirable financial development is one that ensures that sector balances in the economy are maintained. Received theory and evidence has it that financial intermediation has the effect of siphoning funds from the household sector and from the informal credit markets on which such households depend, to the official financial institutions to which they have no access (Jansen, 1989b; Yap and Vos, 1997). The inherent bias of official financial institutions on allocation of their loans against the rural sector and small-scale firms has been seen in many cases. Liberalisation of the official financial system is usually expected to increase access of household firms to bank credit. However the overall impact on resource allocation has been to shift more resources from the small-scale household firms to the sector of large-scale firms.

This is likely to continue unless the behaviour of banks is changed. The impact of this trend becomes more impeding in the development effort in a country like Tanzania where the majority of the economic agents are in small-scale rural and urban firms.

Trends in performance of the agricultural sector determine the general performance of the economy. Reforms in the country have also encompassed the agricultural sector, in recognition of its primal role. These have included among other measures, the introduction of market determined incentive structures, improvement in the functioning of markets for factors of production and strengthening the responsible ministry's duties in relation to extension services, policy and sector performance monitoring. As far as the financial sector is concerned there is mention of the need of the financial sector “to be able to lend commercially for agriculture” and measures to reduce “financial risk in lending to agriculture”. The suggested measure to achieve the second objective is crop insurance schemes. The development of rural savings and credit associations based on farmers' groups are encouraged. No specific policy framework has been spelt out in the existing policy document to address the set objectives.

In order that poverty reduction is taken care of, the challenges of financial sector development is the building of agricultural financing mechanism. It is well recognised that financial institutions operating on commercial principles would tend to avoid the rural sector. Its smooth financing requires a special approach by the Central Bank and government.

In recognition of the urgency of credit for rural development, a Rural Finance Department was established at the Bank of Tanzania with precise duties and responsibilities spelt out.
The work of the Rural Finance Department was not confined to the Bank of Tanzania, but extended to other financial institutions and authorities connected with agricultural development. This Department ceased to operate after the restructuring of the Bank.

Past experience indicates that the agricultural sector (small holders in particular who are the poorest), has been receiving little credit from formal institutions. Caskey (1992), for example, observed that of the total commercial bank credit in 1988, 75 per cent went to only twenty borrowers most of whom were parastatals and co-operatives with only 3 per cent going to the private borrowers.

The rural population in Tanzania, like the case in most developing countries, depends more on informal private lending than public institutions. A study by Hyuha, Ndanshau and Kipokola (1993) testifies this for the Tanzanian case. The proportion of institutional borrowing to total borrowing, ranges from 20 per cent to 35 per cent among surveyed households.

Cumbersome credit conditions
A good many of the public credit institutions lend rather little of their funds to small farmers. Under a liberalised financial sector where the private sector is the main player the situation is not likely to get any better. The paper work requirements by government and banks from borrowers are almost unattainable by the poor. There are cumbersome registration procedures and banks require a multiple of documentation.

Table 5 Comparative Business Start-up Delays (Selected African Countries)

<table>
<thead>
<tr>
<th>Country</th>
<th>Import processes (days)</th>
<th>Land allocation (weeks)</th>
<th>Investment approvals (weeks)</th>
<th>Obtaining work permits (weeks)</th>
<th>Business registration (days)</th>
<th>Obtaining Building permit (days)</th>
<th>Business license (days)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Namibia</td>
<td>3</td>
<td>12</td>
<td>-</td>
<td>6</td>
<td>4</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>Ghana</td>
<td>6</td>
<td>20</td>
<td>1</td>
<td>2</td>
<td>5</td>
<td>15</td>
<td>-</td>
</tr>
<tr>
<td>Uganda</td>
<td>8</td>
<td>15</td>
<td>5</td>
<td>4</td>
<td>5</td>
<td>10</td>
<td>1</td>
</tr>
<tr>
<td>Tanzania</td>
<td>12</td>
<td>50</td>
<td>14</td>
<td>16</td>
<td>6.2</td>
<td>50</td>
<td>30</td>
</tr>
</tbody>
</table>

Source: Coopers and Lybrand (1997)

The possibility of poverty reduction in the country lies in development of small farmer households who predominate in agriculture. There has been recognition of this fact by the government but what has been emphasised is the urge to raise productivity of farm labour. Low productivity of farm labour cannot be overcome without credit to finance certain factor inputs. There is eventually the need to steer rural credit into productive projects and into the hands of the poor.
Financial reforms need to embrace the concept of availability of credit to the households both in urban and rural areas. It is notable that several credit institutions were established by the government for the good intention of channelling credit to households. These included national development banks, specialised agricultural credit institutions, the commercial bank, co-operatives and other government supported project authorities. However, no substantial changes were achieved in the rural areas. The result has been siphoning of surplus funds accumulated through the rural sector and used by the banks as credit base for the more profitable urban sector. Banks are not interested in giving small loans. What the households need are small loans for such small investments like a sewing machine, or pesticides, which require small amounts of money. They usually have no choice but to go to the local money lender who is always around.

Table 6 Typical Bank Credit Terms and Conditions For Loan Applicants

<table>
<thead>
<tr>
<th>Credit Terms and Conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Tenor, validity and availability</td>
</tr>
<tr>
<td>• Interest rate</td>
</tr>
<tr>
<td>• Commission</td>
</tr>
<tr>
<td>• Collateral in the form of fixed assets (preferably non-residential buildings), the value of which must be 1.5 times the amount of the loan</td>
</tr>
</tbody>
</table>

Information to be supplied with the application

• Company and/or project background and projections
• Valuation report of the property intended as security
• A copy of Memorandum and Articles of Association
• Copies of Business License and certificate of registration
• Detailed Curriculum Vitae for the company’s management and the company’s directors and shareholders
• Audited accounts of the company for the past three years

Source: Survey

The characteristics of different users of credit should be put on board in reforms. It is specified in Kimei (1994) that BOT has recognised the need to intervene in the operations of banks in an attempt to direct credit to the rural sector. Again directing credit to the rural sector does not ensure that it reaches the poor households.

The Bank of Tanzania needs to have arrangements for agricultural credit that provides adequate, effective and continuous co-ordination among the financial institutions and itself. The role of a Central Bank in economic development should not be limited to regulate money supply and prices. It should be able to influence development of the different sectors of the economy e.g. agriculture, small-scale industry, and small businesses which tend to be neglected by financial institutions working with the profit motive (Aryeetey, 1994).
During the 1970s the government emphasised the role of the Central Bank to go beyond initiating, building and evolving financial institutions and facilitating development. BOT then established the Rural Finance Fund (BOT, 1979). The fund promoted development through provision of refinance facilities, guaranteeing of loans, training of personnel and supervision and inspection of financial institutions.

While the Central Bank’s immediate target of price stability has some growth attainment objectives, its institutional duty to supply the economy with the amount of liquidity sufficient for smooth production of goods and services is also important. Remaining committed to monetary programmes at “whatever cost” turns out to be undesirable especially to micro enterprises relying on bank credit with no alternative sources of finance.

In summary, the tendency of credit flows to be biased against small borrowers, who eventually happen to be the largest proportion of the economic agents has to be reversed. Existing financial reforms do not promise to reverse this trend, as financial institutions are required to operate commercially and intervention from the government or central bank is supposed to be minimal. The reforms actually aim at increasing the returns on official financial institutions, as the more ‘time’ and ‘savings’ deposits that are being encouraged would imply more flow of funds to them. There is therefore need for appropriate analysis that would unveil the crucial effects of financial development among different economic agents and hence address structural growth of the economy. This can take place by:

- A higher ranking of the role of rural and micro-level economic agents
- Increasing institutional savings through higher interest rates and organising savings institutions.
- Development of credit institutions for the poor
- Increasing the allocative efficiency of financial intermediation
- Increase the developmental role of Central Banking

CONCLUSION
What comes out of the paper is that economic policies have correctly focused on the important role of financial development in overall economic development. In the financial sector the reforms main elements have entailed the removal of financial repression as manifested in low or negative interest rates and credit rationing and monopoly in commercial banking. However, the ongoing reforms have not contributed significantly towards alleviating poverty.

Performance analysis of the financial sector does indicate unsatisfactory results in terms of financial development indicators and credit flows among the priority sectors although some positive achievement has been recorded in reducing
inflation. In addition, several emerging issues that might have undesirable impact on the economy are identified, the most salient one being neglect of finances to agriculture, where the most poor are.

The implications of the issues are that for financial liberalisation to be conducive to economic development and poverty reduction, an approach that takes into account the existence of different economic agents and therefore attacks both macro- and micro-level constraints seems inevitable. If the objective is to bring about structural growth, the differential impacts of reforms on the various sectors that make up the economy might need institutional interventions. 7

The Central Bank’s role in developing the financial system has to be broader, in enhancing the link between the financial sector and the real sector, which is the main objective of financial development. This then implies increased efforts to monitor what is happening in the real sector in terms of production and distribution. The interaction of the actions of the various economic agents as are affected by monetary and financial flows requires building link between official and unofficial institutions. This is because local institutions have been and will remain to be the main source of investment funds for households and the unincorporated sector in their fight against poverty.

Under the framework of current reforms, financial deepening would involve increasing the lending capacity of the financial system to provide finance for micro-enterprises in the informal urban and rural sectors by encouraging new types of financial institutions such as venture capital companies, and increasing access to credit by the poor by rationalising loan procedures and providing conditions for the use of land as collateral.

The study has faced one main limitation though. To be more elaborate we would need precise empirical information and data on the flow of financial variables at the household level. This however is only possible with availability of flow-of-funds data that would allow us to link the monetary and financial flows to the “real side” of the economy.
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Conventionally M2 is defined as Currency in circulation, plus demand deposits and M3 is M2 plus savings, and time deposits. More recent re-definition extents M2 to include savings and time deposits while M3 would be M2 plus foreign currency deposits.

Group lending is one approach for reaching poor people. In Tanzania we have the Credit Shop Scheme run by Poverty Africa. This program provides group lending in both urban and rural areas.

Tanzania is an economy where the population dominating the sector, which the banks have been reluctant to supply credit, is comprised of households and unincorporated enterprises. If the distorted behaviour of banks cannot be corrected, the intended developmental impact of financial liberalisation is not likely to be effective.

In its most strict sense, liberalisation means non-intervention by the authorities. It is assumed that financial institutions will make objective decisions. Objective decisions for them imply ensuring the safety of loans. But efficient decisions to banks may not be necessarily efficient from the social point of view; this then brings the need for intervention of some kind.

Liberalisers have never argued that effective supervision and regulation are not required but object to routine official interference of a discretionary (as opposed to rules based) kind.