

***Progress of Financial Sector Reforms
in Tanzania
and the Challenges Ahead***

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PROGRESS OF FINANCIAL SECTOR REFORMS IN TANZANIA AND THE CHALLENGES AHEAD

1.0 INTRODUCTION

Financial sector reforms are being implemented in virtually all countries undertaking structural adjustment programme as part and parcel of the economic reform measures. These reforms are crucial in view of the difficulties being encountered in mobilising external finance, the integration of domestic economies into the global economy, the globalisation of capital markets, and the adoption of a market-oriented approach to development. The above factors have made it necessary for countries with underdeveloped financial systems to improve and modernise the financial system to make it viable and capable of promoting economic development.

Policy makers in countries with underdeveloped financial systems are bound to address themselves to the problem, and challenge they have to face is how the financial sector reforms should be formulated, designed, sequenced, and implemented. It must be noted that, the design and implementation of the financial sector reforms is complicated and often takes relatively long in an environment where the major borrowers are state enterprises, and the institutional capacity is weak. Under such circumstances, the formulation and implementation of financial sector reforms are undertaken within broad overall economic reform programmes, in which macroeconomic stability and the liberalisation of the real sector are an integral part.

- Banking services which are concentrated in urban areas.
- Financial institutions mainly focus on financing trade related activities.
- Financial institutions that are incapable of tapping resources available in the international capital markets.
- A financial system that does not provide financial services to rural sector operations and small scale enterprises.
- The informal sector plays an important role in the mobilisation and allocation of financial resources.

2.3 Why Financial Sector Reforms are Necessary at this Point in Time

- To make financial institutions financially and operationally viable so that they can efficiently mobilise both domestic and external resources for allocation to the productive sectors and promote growth.
- To tap private capital flows through the financial system as the official external resources to developing countries are dwindling.
- To facilitate the adoption of market-oriented approach to development.
- To intergrate domestic economies into the global economy.
- To take advantage of the globalisation of the capital markets.

2.4 What Financial Sector Reforms Generally Aim at:

- Putting in place appropriate legal, regulatory and supervisory framework, to provide a conducive environment in which financial institutions can operate.
- A legal infrastructure that is transparent and ensures fair play, and one which is capable of enforcing contracts and resolving conflicts, timely.

- Opening-up entry into and exit from the sector with a view to enhancing the framework for competition, and promoting the efficiency and development of the money and capital markets.
- Strengthening the monetary policy role of the Central Bank towards attainment of price stability.
- Strengthening the role of the Central Bank in supervising the financial system.
- Minimising direct involvement of Government in the financial sector by privatising publicly-owned banks.
- Restructuring existing banks both financially and operationally to restore their soundness i.e. by way of providing adequate capital, modernization and enhancing the managerial and technical skills of personnel.
- Broadening the range of financial institutions and instruments to improve the process of financial intermediation.
- Modernising the payments system to enhance efficiency in financial transactions.
- Providing an enabling environment for the efficient functioning of financial markets, leading to the achievement of market determined exchange rates and interest rates.

2.5 Preconditions for Successful Implementation of the Financial Sector Reforms.

For financial sector reforms to be effective, they must be preceded by the establishment of appropriate institutional and economic conditions, including:

- A stable macroeconomic environment characterised by low inflation, appropriate deposit and lending rates and stable exchange rates.

- A well functioning payments and settlement system.
- A supportive legal framework.
- Effective banking regulation and supervision.
- Reforms in the real sector (where borrowers are generally financially distressed) to provide a strong client base for the financial sector.
 - Create and maintain a conducive environment for the development of the private sector.
 - Improve the performance of state enterprises, and speed up their privatisation.

3.0 FINANCIAL SECTOR REFORMS IN TANZANIA

3.1 Background to Financial Sector Reforms in Tanzania

The Tanzanian economy suffered serious macroeconomic imbalances beginning late 1979 which were manifested by:- declining domestic production leading to shortages of consumer goods, rapid increase in consumer prices, an increasing budget deficit, a widening balance of payments deficit leading to accumulation of payment arrears, the depreciation of the currency and the emergence of a parallel market for foreign exchange. The macroeconomic imbalances, which in particular, led to a substantial devaluation of the currency, caused serious damage to the financial sector, setting pace for insolvency and inefficiency that later came to be associated with it.

The damage to the financial system, which was dominated by state banks and financial institutions, was mainly caused by losses suffered by public sector institutions, namely, public corporations (parastatals), cooperative unions and marketing boards, which had heavily borrowed from the

financial sector, but unable to service their debts due to the huge losses they had suffered.

Following these developments, the Government adopted the Economic Recovery Programme (ERP) in 1986, to address the problems in the financial sector and the economy as a whole. It is through the ERP framework and the subsequent Structural Adjustment Programmes (SAPs), by the IMF and the World Bank, that the financial sector reforms were formulated, designed, sequenced and implemented.

- During the first phase of SAP (1986/87 - 1988/89), recovery measures were directed mainly at economic stabilisation and the liberalisation of trade and prices within the country.
- During the second and subsequent phases of SAPs, in addition to macroeconomic stability, measures were also directed at addressing structural bottlenecks in the financial and real sectors of the economy, as well as at liberalising external trade and removing exchange restrictions.
- It is in this context that in July 1988, the President of the United Republic of Tanzania appointed a Presidential Commission to look into the problems of the financial sector, and to recommend to the Government the strategy that should be adopted in reforming the financial sector in Tanzania.

3.2 The observations of the Presidential Commission regarding the state of the financial system in Tanzania.

- There was gross interference by the Government in the day-to-day operations of public corporations, cooperative unions, marketing boards and financial institutions, which adversely affected their operations.
- Commercial banks had a huge volume of non-performing loans of their major clients-- public sector entities-- which rendered them unprofitable and technically insolvent.
- Commercial banks' relied excessively on Central Bank financing due to insufficient deposit mobilisation efforts.
- The general public had lost confidence in the commercial banks ability to provide services at reasonable cost, speed and courtesy-- they had ceased to fulfil even the limited function of offering an efficient means of payment in the economy.
- There was lack of competition since private banks had been nationalised in 1967. The specialised publicity-owned banks assumed a monopoly position and became insensitive to the opportunities and constraints in the market.
- There was lack of financial instruments to mobilise medium and long-term savings except for Government bonds.
- There were a few financial instruments through which private savers could invest.
- The economy was experiencing macroeconomic instability which adversely affected even the good performing bank customers, particularly those who had contracted foreign loans.

- There were managerial weaknesses in financial institutions which undermined the performance of both the financial and the business sectors.

3.3 Major recommendations of the Presidential Commission on the Reform of the Financial Sector in Tanzania.

- A new banking and financial institutions law be enacted to give all banks the same basic operating conditions and allow for competition.
- Boards and managements of banks should be given full discretionary powers to run banks, basing their decisions on sound banking principles.
- The banks operations should be modernised and systematised i.e. through automation and improvement of internal controls and procedures to provide increased security and customer service.
- The banks should be capitalised adequately.
- The major customers of the banks, namely public corporations, marketing boards and cooperative unions, should be rehabilitated.
- NBC should be restructured and split into three banks, of roughly equal size, each with a national profile. Ownership of these banks be diversified, with one whole owned by Government.
- The Insurance Sector should be reformed in order to promote a competitive environment, that would lead to better service and protection of policy holders' interest. A new insurance legislation was proposed in this regard.
- NIC be split into two corporations - the first to handle life insurance business and the second to handle general insurance business.

- Management of pension funds be transferred to the company handling life insurance business until when the National Social Insurance Scheme is introduced.
- A Capital Market Authority or Board should be established to facilitate mobilisation of domestic and foreign resources for long term investments in productive activities.
- Unit Trust and Mutual Funds be established to facilitate the pooling of savings from small investors for investment in large projects, as well as spreading these investments over a large number of projects to minimise risk.

3.4 Implementation of Financial Sector Reform Measures

In line with the recommendations of the Presidential Commission, and in the context of the overall economic reforms, the following measures to reform the financial system have been implemented:

- On macroeconomic stability, there has been:
 - Introduction of Treasury bills market
 - Introduction of the cash budgeting system to control Government expenditures.
 - Revenue enhancing measures through improved tax administration (TRA)
 - Stopping commercial bank borrowing from the Central Bank.

As a result of these measures, today there has been considerable achievement in macroeconomic stability.

- Measures to reform the legal framework to allow for competition in the delivery of financial services;
 - Banking and Financial Institutions Act (1991) paved the way for the licensing of new banks and financial institutions. To date BOT has licensed 16 commercial banks and 9 non-bank financial institutions.
- Measures to recapitalise the banks and to deal with the large portfolio of non performing loans;

The Loans and Advances Realization Trust (LART) was established in 1991 to assume and subsequently realise non-performing loans of publicly - owned banks. The non-performing loans of NBC and CRDB were transferred to LART in 1992 and 1993 and were replaced by 20 year Government bonds, carrying 11% interest per annum. The banks were also recapitalised.

- Measures to liberalise external trade and the foreign exchange regime:
 - The Foreign Exchange Act was enacted in 1992 to provide for an enabling environment to facilitate an efficient allocation of foreign exchange resources and for the determination of market foreign exchange rates.
- Measures to introduce a market for mobilising and allocating savings for medium and long term investments:
 - The Capital Markets and Securities Act was enacted in 1994 to put in place an enabling environment for the establishment of a stock market to provide capital for long term investment as well as enhance the role of the private sector in the economy.

- The Capital Markets and Securities Authority was established to oversee the above.
- Dar es Salaam Stock Exchange to open soon.
- Measures to rehabilitate and improve the performance of the public corporations and to develop a strong client base for the financial sector:
 - The Parastatal Sector Reform Commission was established in 1993 with a view to restructuring and privatising the over 350 state enterprises. So far over 137 state enterprises have been divested.
- Measures to strengthen the monetary policy and bank supervision roles of the Central Bank, to ensure attainment of price stability and soundness of the financial system:
 - A new Bank of Tanzania Act was enacted in 1995 to focus the primary role of the Bank of Tanzania to that of fostering price stability.
 - Bank Supervision has been strengthened.
- Measures to liberalise and restructure the Insurance Sector:
 - After a long delay, the Act to liberalise the Insurance sector was passed by Parliament in February 1997.
- Measures to restructure publicly-owned banks:
 - These have been on-going since 1992.... CRDB was fully restructured and privatised in 1996.
 - THB was closed in 1995.
 - Restructuring of NBC and PBZ continues.

4.0 THE CHALLENGES AHEAD

- Measures to restore macroeconomic stability are now firmly in place - the challenge is to ensure that they are sustained.
- Measures to reform the legal framework to allow for free competition in the delivery of financial services are in place, except for the measures that will open-up the management of pension fund schemes. The Government is urged to put in place the legal framework that will regulate entry and supervise private pension funds which will compete with the existing schemes.
- Additional measures are required to modernise the laws that govern the introduction and use of financial instruments. Besides, a lot needs to be done to improve the administration of justice so that courts are not used to deny justice to the financial institutions through injunctions. In this regard, the setting-up of commercial courts is long overdue.
- Measures to introduce a market for mobilisation and allocation of savings for medium and long term investments need to be completed. The opening of the Dar es Salaam Stock Exchange should be speeded-up.
- The measures to rehabilitate and improve the performance of the major customers of the banks lag behind the other reforms:

- The PSRC has so far restructured and divested only 137 parastatals out of over 350 state enterprises. This process has to be accelerated.
 - Government is strongly urged to promote the development of a strong and dynamic private sector in order to develop a viable client base for the financial system.
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- Measures to restructure publicly-owned banks should also be accelerated. The splitting of NBC into three banks will not only facilitate the minimisation of Government involvement in the banking business, but will also enhance the Central Bank's capability in using indirect instruments (which are more market friendly) to conduct monetary policy.
 - A well functioning payments and settlements system in Tanzania is still lacking. In this regard, the financial institutions should develop a modern and efficient payments and settlement system capable of conducting financial transactions speedily--We should be aiming at real time gross settlement system.
 - The financial needs of rural and small scale producers have not been addressed by the financial sector reforms taking place in Tanzania - the situation has become even worse as bank restructuring has resulted in the closure a number of branches operating in the rural areas. There is an urgent need to provide a financial system that caters for the needs of the people in these areas.

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