FINANCIAL LIBERALIZATION - INTEREST RATES AND LENDING BEHAVIOUR IN TANZANIA: 1984 - 1997

Fredrick M. Ruhara

Abstract: The experience with financial liberalization is rather mixed. There are success stories and there are cases of failure. However financial sector liberalization school predicts improved performance if there is right sequencing of the reform programme. Increased savings following from increased positive interest rates, increased efficiency in the allocation of credit and financial integration in the economy are some of the expected outcomes.

Tanzanian experience and that of other countries show that the expectations about financial sector liberalization are not attainable even where there is the right sequencing of the reform process. In particular capital rationing under financial sector liberalization is not explained by this school. This paper studies the Tanzanian experience in light of the experiences from other countries and finds out that the expected results on interest rates and lending behaviour are not as predicted. These contradictory outcomes are explained using the new institutional school. The timing and sequencing of the reform programme is also analyzed to check whether it might have influenced the results.

INTRODUCTION

According to the McKinnon-Shaw (1973) thesis on financial sector liberalization, financial liberalization facilitates economic growth and development. In this view government intervention lead to financial repression. Financial repression includes such policies as control of interest rates, imposition of credit ceilings, use of credit rationing, high levels of inflation and public sector deficits. These policies lead to shallow finance. Low and negative interest rates, a narrow range of financial products and an unsatisfied demand for credit to be rationed by means other than interest rates are observed. Financial sector reforms that eliminate these distortions enhance financial deepening and increase savings mobilization. There is a complementary hypothesis that links money balances and physical capital accumulation. McKinnon suggested that developing economies had limited access to external finance. Since investment outlays are lumpier than consumption expenditures, investors must first accumulate financial assets before investing in physical assets. This suggests that money balances and physical capital are complementary.

Shaw (1973) on the other hand underlined the importance of an efficient and well functioning financial system. According to him, higher deposit rates increase financial savings and give impetus to financial institutions to intermediate funds between surplus and deficit units. He said that financial institutions are able to increase returns to savers because they harmonize liquidity preferences and lower information costs as well as facilitate exploitation of economies of scale in banking and risk pooling in the saving investment process. Therefore both McKinnon and Shaw decried financial repressive policies.

Therefore with increased competition resulting from financial liberalization policy, we would expect positive real interest rates and low interest rate spreads. Due to increased competition in the banking system the expectation is that interest rate spreads should narrow down. Financial integration is also expected and the difference between formal and informal finance should disappear. Efficiency in the allocation of credit and portfolio management is also emphasized in the literature. There is also an important expected change in lending behaviour. The hitherto marginalized borrowers should have now greater access to credit. The difference between small firms and

large -scale firms or private and public sector enterprises in the access to credit should diminish.

Other proponents of financial liberalization in recent years have cautioned that the impact is rather mixed. Empirical tests fail to lend support to the financial liberalization hypothesis. Diaz-Alejandro argues that financial liberalization can lead to instability and questions the efficiency allocation role of the banks. Seck and Nil (1993) says that the policy may not reduce interest rate spreads unless there is reduction in reserve requirements or if regulation is not followed up with increased competition. Gonzalez Arrieta (1988) notes that the design of financial sector reforms is an important factor. Nissanke (1994) puts emphasis on the speed and sequencing of the reforms as well as the macroeconomic stability, prudential supervision and regulation of the banking system. Finally Aryeetey et al. (1997) notes that fragmentation of financial markets has persisted because of incomplete reforms and lack of attendant measures to address institutional and structural constraints. Alawode and Ikhide (1997) give sufficient theoretical background to the sequencing, timing and speed of financial reforms.

Country experiences show the mixed results of financial liberalization. Here we examine briefly the experiences of Turkey and Indonesia for the periods 1980-1989and 1983-1990 respectively, and the African case is illustrated by looking at Malawi in the period 1987-1994. Turkish and Indonesian experience sighted above show that financial liberalization is a necessary but not sufficient condition for the efficiency in credit allocation. Turkey implemented financial sector reforms during the period 1980-1989. This was a period of inflationary environment. The level of uncertainty and market risk increased that in turn impacted upon the banks. Very highly positive results in savings mobilization were achieved and yet banks did not allocate all of these funds to borrowers and credit allocation was rather distorted. Banks now tended to lend to certain sectors, clients, and desired maturity and risk premium of projects changed. Larger customers were preferred to small clients. Projects of short maturity to avoid inflation were given priority. Risky but high return projects were rejected while borrowing was conditional on 100% collateral. There was also an increase in the cost of capital and foreign firms had easier access to capital in order to guard against the value of principal and interest repayments. Low risk sectors such as short-term working capital, domestic credit from trade, consumer credits, Government bonds and treasury bills became the most popular lending instruments.[1]

In Indonesia, the reforms were initiated in 1980. Interest rate liberalization was initiated in June 1983 when the country was facing macroeconomic instability due to inflationary and fiscal deficits. High and volatile interest rates resulted and the volume of nonperforming assets increased. However, real interest rates turned from negative to positive since 1983 and the spread between lending and deposit rates declined showing some competitiveness in the banking system. Later in early 1990 interest rates began to decline as a result of a deliberate monetary expansion that was achieved at the expense of inflationary pressures. The monetary squeeze pursued later did not bring down the interest rates to their pre-deregulation levels until 1990. The other positive effects were in financial deepening, decline in public investment and profitability in the short-term and the increase in access to external funds for small firms. Overall, the share of public investment and profitability remained higher than for the private sector. Financial sector efficiency and stability was not achieved.[2]

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1 See Pehlivan (1996) for details

2 Fischer (1994) and Skorsk (1994) give the Indonesian experience

Malawi implemented financial liberalization reforms beginning 1987. Chirwa reports on the impacts on financial deepening, savings mobilization, interest rates, interest rate spreads, shifts in sector allocation of domestic credit and profitability, and monopolistic power of the banks. A significant increase in financial deepening and savings mobilization is reported. There was an increase in the share of savings and time deposits indicating a trend towards medium and long-term savings behaviour. Interest rates increased but deposit rates were below inflation rates although real lending rates were recorded and the monopolistic power of the banks decreased.[3]

The most negative features of the liberalization efforts were changes in interest rate spreads and sector allocation of credit. Interest rate margins significantly increased and credit allocation favoured large-scale and well established enterprises. Manufacturing and trade sectors were also given more emphasis contrary to the expectation of the reform effort. The dominance of the agricultural sector fell. Although loans to the private sector increased, the share of the private sector decreased when compared to that of the public sector. Therefore the micro-enterprise sector was not encouraged. The loans and advances as share of total assets also fell significantly. The trend in profitability also went in the same direction as change in credit allocation (with the decreased performance of the agricultural sector).

Aryeetey et al. (1997) has documented the impact of financial liberalization in Tanzania for the period up to 1993. Their contribution focuses on financial fragmentation. They maintain that financial sector liberalization cannot be enough to solve the financial fragmentation problem because of Structural and institutional barriers existing. They note that there were weak linkages between formal and informal finance and interest rate differentials were not explained by differences in costs and risks. Funds and information did not flow between financial market segments. They also report the impact of financial liberalization on deposit mobilization, credit allocation, interest rate spreads and portfolio management. Saving mobilization increased with demand deposits declining and time deposits reflecting a rising trend. A dominance of short liquid instruments was found.

With regard to lending by commercial banks, the share in private sector lending increased but the share of public sector lending remained high. They also report that there was no significant change with respect to share of credit going to the micro enterprise sector and short-term credit lending dominated. They find strong great improvement in the informal credit demand and supply largely due to market liberalization. There was an initial increase in the level of interest rates as expected but lending rate spreads and excess liquidity continued due to oligopolistic structure of the banking system, high cost of funds and reserve requirements. This meant inefficiency in the credit allocation process.

In terms of portfolio management, they report a crowding out of the private sector by high yielding government securities, smaller average loan sizes for informal finance than for formal banks and medium term and long-term loan. The constraining factors emphasized were weak infrastructure and poor information that resulted in policy uncertainty for good opportunities with insufficient collateral. The level of non-performing assets also increased. The World Bank report (1994) on Tanzania also notes some shortcomings. It points out that there were delays in restructuring parastatals and there was a continuous extension of credit to poorly performing parastatals. This deteriorated bank's net worth increasing cost of balance sheet restructuring.[4]

3 For further reference, see Chirwa (1999)

4 Montiel (1996) gives a brief overview of the immediate impact of financial liberalization in Sub Sahara Africa

In this paper our task is first to up-to-date Aryeetey findings (as the data related to the period up to 1993) and provide a more rigorous analysis of the empirical results. Then we extend the analysis in other directions not pursued by the author. We give a more vivid explanation of the results than what Aryeetey et al. provide along the lines of the new institutional economics school (NIE) and examine timing and sequencing issues of the reform process. Our main hypotheses to be tested derive from the aforementioned economic background. These are:

1. Financial sector liberalization did not have significant difference on the pattern of interest rates, interest rate spreads and structure of savings in the commercial banking system. We test this by using a test of the difference between means of the pre-liberalization period and post liberalization period.
2. Financial sector liberalization as predicted by Mackinnon- Shaw thesis is sufficient to solve the credit-rationing situation observed in repressed financial credit markets. This is tested by looking at the impact of interest rate liberalization on credit allocation and portfolio management.
3. Timing and sequencing of the reform process had a significant influence on the liberalization experience observed in Tanzania. This is tested analytically by studying the liberalization experience itself.

TANZANIA'S EXPERIENCES: 1984-1997

We examine the empirical evidence on Tanzania by comparing the period after financial sector liberalization (1991-1997) and the period before liberalization (1984-1990). Indeed, it would have been better to divide the period of financial liberalization into two, namely period of partial liberalization (1991-1993) and period of full liberalization. However the first period is too short for any meaningful statistical testing. 1984 was selected as a starting period on the basis of equalizing the periods before and after liberalization. We use the test of the differences between means to test the above hypotheses as earlier said.

We start off by looking at the structure of savings This is given in the table below. The average trends computed from these figures and hypothesis tests are also given in table lb. We can observe certain changes. The trend shows an increase in currency and a preference for savings deposits in comparison to demand deposits. The decrease in demand deposits and the change in savings deposits are significant at the 95 confidence level.

Table 1a: *Structure of savings*

Year	Currency	Demand deposit	Time deposit	Savings deposit
1984	34.7	33.6	22.6	9.20
1985	32.7	32.2	25.2	9.90
1986	36.4	34.8	19.2	9.50
1987	37.1	34.1	19.2	9.50
1988	35.5	37.7	16.2	10.6
1989	35.8	36.0	18.1	10.1
1990	35.4	32.6	21.4	10.5
Average	35.4	34.4	20.3	9.90
1991	30.9	35.1	21.1	12.9
1992	33.5	31.7	21.9	12.9
1993	33.3	34.0	23.7	17.2
1994	36.2	31.5	17.4	14.8
1995	39.9	30.0	14.9	15.3
1996	37.6	28.0	17.9	16.5
1997	37.9	27.1	16.6	18.4
Average	35.6	31.1	19.1	15.4

Source: Computed from Bank of Tanzania Bulletin Dec. 1997.

Table 1 b: *Testing for significant change in structure of savings*

Item	1984/ 1990	1991/ 1997	T-Value	Change
Currency	35.4	35.6	0.22	Insignifica
Demand deposits	34.4	31.0	-2.5	Signifi (-)
Time deposits	20.3	19.1	-0.98	Insignifica
Savings deposits	15.1	17.3	8.73	Signifi (+)

The table below also shows trend in savings deposit rate when compared to lending rates. The spread as difference between deposit rates and lending rates and as a percentage of lending rates is also given in the table. The spread as a proportion of total lending was increasing between 1991-1994 but showed a declining trend during 1995-1996 before rising again from 1997. The interest rate spread increased during the period 1992-1996 in spite of entry of several new banks. The spread is not significant change possibly because both deposit and lending rates increased more or less at the same rate between 1991-1196. Our test of the difference between two means give a significant change for the lending rate (t value of 5.17). Therefore the lending rate has increased and the spread has increased to some extent but is not statistically significant. This phenomenon of a rising lending rate is contrary to the expectation of the financial liberalization school as argued above.

Table 2: *Analysis of spreads*

Year	Savings Deposit rate	Lending rate	Spread	% Of Lending
1984	7.5	11.3	+3.8	33.6
1985	10	13.5	+3.5	25.9
1986	10	13.5	+3.5	25.9
1987	21.5	24	+2.5	10.4
1988	21.5	24	+2.5	10.4
1989	26	26	0	0
1990	26	26	0	0
AVG	17.5	19.8	2.3	11.6
1991	26	26	0	0
1992	26	30	+4	13.3
1993	24	30	+6	20
1994	25	31.5	+6.5	20.6
1995	21	35.5	+4.5	12.7
1996	16.7	33.5	+6.8	20.3
1997	10	26.5	16.5	62.3
AVG	21.2	30.4	6.3	20.8
T	0.70	5.17	2.01	0.69

Source: Computed from *Bank of Tanzania Bulletin* and Economic and Operations Reports, December, 1997

We can further investigate the question of change in portfolio management. Table3 gives analysis of bank assets. The change can be seen from the pattern of investing in domestic assets as ratio of total assets. This ratio rose from average of 11.6 to 14.4 for securities and declined from 55.4 to 29.6 for loans. The change in loans is highly significant. As a whole there is no significant change in government securities, but the ratio for treasury bills has been increasing from 0.3% in 1993 to 10.1% and 7.1% in 1996 and 1997 respectively. These figures indicate that the banking system was diverting its deposits from loans and bills to other assets. This result is contrary to the expectation of the financial liberalization school.

Table 3: *Analysis of Commercial Bank Assets*

Year	Cash and reserves	Govt securities	Loans and bills	Fixed assets
1984	3.9	38.7	38.8	2.0
1985	4.5	23.5	49.1	2.7
1986	2.9	8.9	65.3	4.2
1987	4.0	4.7	71.3	3.6
1988	5.3	2.8	70.5	3.2
1989	1.8	1.4	45.6	2.5
1990	2.1	1.1	47.1	3.1
AVG	3.5	11.6	55.4	3.0
1991	2.2	0.7	44.1	3.4
1992	2.4	7.0	36.6	3.9
1993	3.3	12.8	33.0	3.9
1994	6.8	15.7	39.6	6.8
1995	5.1	13.0	20.2	4.2
1996	8.2	29.0	16.7	6.6
1997	5.4	22.4	16.8	0.1
AVG	4.8	14.4	29.6	4.1
T	2.2	0.48	5.14	2.5

Source: Computed from Bank of Tanzania Bulletin and Economic and Operations Reports, December 1997

Our next consideration is the growth of savings and the allocation of credit between the public and private sector. The following statistics give the trend: The figures show that while there was increased savings ratio between 1994-1997, Credit allocation to both public sector (PU) and private sector (PR) tended to decrease except

for 1997. This was particularly strong for the private sector.

We extend the analysis by focusing on the loan deposit ratio and the proportion of credit going to the productive versus the unproductive sector Our expectation is towards an increased loan deposit ratio and more allocation of credit to the productive sector as financial liberalization is supposed to increase the efficiency of resource allocation.

Table 4: *Growth of domestic savings and allocation of credit in % during the liberalization period 1991-1997*

Variable	'91	92	'93	'94	'95	'96	'97
Savings ratio as % of GDP	2.2	1.5	-2.4	-1.0	2.0	3.6	5.4
Credit PU (% cahange	1	55	40	7	23	-4	-12
Credit PS (% change	32	-12	40	20	-10	-42	43

Source: African Development Indicators, 1998
PU = Credit to public sector and PS = Credit to private sect

The hypotheses are as follows:

Ho: Average loan deposit ratio and proportion of credit to the productive sector in the pre-liberalization period and the post period are not significantly different. We do this analysis by comparing the 1984-1990 and 1991-1997 periods with respect to these variables. Table 5 shows a declining loan deposit ratio. There is a downward trend in the credit flow to borrowing sectors. This may indicate increased risk on the part of the banks to make loans in the face of increased lending rates during the period as seen in the table above. It also indicates the possibility that the banking system was diverting its deposits to risk free government securities. This was seen from the analysis of the pattern of bank assets. This ratio greatly increased particularly since 1995 when compared to the previous years.

The average proportion spent on Agriculture between 1991-1997 was 8.6% as compared with 6.3% for period 1984-1990. This is significantly different as seen from test. The table also shows that there were significant changes in allocations to manufacturing (including mining) and to the marketing sector. For the productive sector as a whole the average is 30.8% for 1984-1990 against 20.3% for 1984-1990. This is a significant change. Thus there seem to have been a better credit allocation in favor of the productive sector though the bias is towards mining and manufacturing as compared to agriculture. Perhaps this increase in credit flow was encouraged by a drastic reduction on credit going to marketing of agricultural produce, which in the pre-reform period was forced on the banks by the government to finance the cooperatives. Private trading provided the needed funds in the reform period.

The comparison may also be made difficult by difference in the degree of credit squeeze put on the banks between the two periods. The credit squeeze was stronger in the previous period compared to the lafter period. There is no significant difference in credit allocated to the export trade sector between the two periods. This is not a healthy situation as one would have expected a higher tendency towards this lucrative but risky trade sector. This is accounted for by reluctance of the banks and good credit worth borrowers to participate in this high risky sector because of the high standards expected for exporters. Comparison with the situation in the 1970s would throw more light. The following picture as evidenced from Table 5 emerges.

The table clearly shows that the productive sector received more emphasis in the 1970s than in the 1980s and 1990s. The banking system has tended to divert some of the loans to less risky sectors. This is even more apparent when we take into account resources loaned to marketing sector. Had we encouraged private trading in the 1970s, more credit would have gone to the productive sector(particularly to agriculture).

Table 5:

Year	Loan deposit ratio	Market or Marketing	Sector Export	Productive AGR	Sector MANUF.	TPS
		%	%	%	%	%
1984	49.4	55.5	18.1	5.0	10.3	15.3
1985	61.1	55.8	25.7	3.7	8.2	11.9
1986	84.4	18.6	60.7	4.9	5.2	10.1
1987	126.4	64.0	12.6	7.3	11.4	18.7
1988	123.9	42.0	13.1	8.2	19.6	27.8
1989	138.8	40.4	32.2	6.2	21.0	27.2
1990	141.4	31.4	22.2	8.4	22.7	31.1
Average	103.6	39.8	23.2	6.3	14.11	20.3
1991	154.3	36.6	23.6	9.6	21.0	30.6
1992	109	24.6	26.7	7.7	19.0	26.8
1993	102.2	25.2	25.8	6.6	18.7	25.3
1994	88.5	26.9	31.4	0.9	26.8	35.8
1995	48.8	19.7	20.0	8.1	21.2	29.3
1996	25.5	6.0	17.4	11.7	25.2	36.9
1997	27.7	15.2	15.1	7.5	23.6	31.2
Average	79.4	22.0	22.9	8.6	22.2	30.8
T	1.06	2.58	0.04	2.5	2.85	2.97

Source: Computed from BOT Bulletins, 1997 and Economic and Operations Report June 1986 & 1995
AGR represents agriculture; MANUF = manufacturing; and TPS =Total for the two sectors.

Table 6: *Allocation of credit in the 1970s*

Year	Productive sector	Trade sector	Marketing
1972	22.7	32.1	31.3
1973	24.7	32.0	33.7
1974	25.7	23.0	29.3
1975	31.3	18.7	31.1
1976	32.5	11.6	27.2
1977	36.1	12.3	23.8
1978	44.0	13.4	44.0
Average	31.0	20.4	71.1

Source: computed from Bank of Tanzania Bulletins, December 1980

Some of these findings are similar to those found by Aryeetey et al.(1997) who also reported inefficient credit allocation, high lending rates and change in portfolio management. The experiences from case studies of Malawi, Turkey, and Indonesia reviewed above seem to suggest that the expectations from financial sector liberalization are far from being perfect. We explain these results, which are contrary to the liberalization thesis by expounding on the new institutional economics school. These two schools of thought differ in terms of interpreting the results when faced with asymmetrical information. The liberalization thesis does not address itself to this problem although financial sector liberalization process increases risk arising from asymmetrical information as will be explained in the next section.

EXPLANATION OF THE FINDINGS

Economic policy and practice has so far been largely influenced by two models, namely the traditional view of credit markets and the credit market as classical competitive markets. The traditional credit market model sees rural markets as monopolistic and high interest rates as consequence of this monopoly power. The policy prescription resulting from this view is provision of subsidized credit. This cheap interest rate policy was also supported by the keynesian economics school, which argued that interest rates should be low in order to speed up the process of capital accumulation. The outcome of this policy intervention in the credit markets led to financial repression and unsustainable financial sector in developing countries.

The classical competitive market model is on the other hand a free market intervention model. It is critical of government intervention and attributes existing high interest rates charged by informal financial markets in the rural are to the monopolistic competition in the agricultural sector. This financial sector liberalization school therefore took this view and interpreted the existence of informal financial institutions as deviation from the competitive market framework.

Financial liberalization experience however, shows that this model fails to explain why there are a few players in the informal financial sector despite a high demand for financial services and high interest rates charged and why there is co-existence of the informal and formal sector finance institutions even where formal interest rates are lower than in the informal sector. The theory also fails to account for the inter linkage between credit and goods markets. Lastly and perhaps the most important weakness is inability to explain the existence of credit rationing situation under financial liberalization. The explanation of this phenomena calls for a different framework of analysis. It is the NIE school that has provided a solution to this puzzle. It is precisely this school that accounts for a credit market-rationing situation in a financially liberalized environment.

The New Institutional Economics School

According to the new institutional economics school (NIE), financial liberalization is a necessary but not sufficient condition for economic growth. The outcome of financial liberalization is mixed. In some cases liberalization has led to sharp increases in interest rates, worsening inflation, widespread bankruptcies of financial institutions, unstable exchange rates and increased external debt as evidenced from case studies above. Various reasons are given for these financial crises.[5]

Experience with interest rate liberalization shows that the equilibrium interest rate generated does not balance the demand for credit with the supply of credit. There is still greater demand for credit compared to existing supply. In other words, the interest rate does not rise enough to clear the market. A credit-rationing situation is therefore created which has to be managed by the banks. The financial liberalization school does not explain this credit-rationing situation in a liberalized environment. It is explained by the NIE.

According to the imperfect information school, Hodgeman (1960), Jaffee and Russel (1976), (Stiglitz and Weiss 1981), Herath (1994, 1996) and Stiglitz (1990), profits from interest income do not increase monotonically with interest rates. Beyond certain limit the returns begin to decline because the probability that the borrower will default on a loan increases at higher interest rates. Therefore banks will not raise interest rates beyond the limit even with excess demand for credit.[6] Financial sector liberalization assumes a direct relationship between interest rates and credit at all levels.

5 *See* Abayomi for this assertion and reasons for the crises

6 The credit rationing school emerged in the 1950s. Among the pioneers of this debate were Hodgman (1960) and Jaffee and Rusell (1976)

The lender does not have information about the willingness of the borrower to pay the loan. With high interest rates, good borrowers willing to pay back tend to refrain from borrowing. But bad borrowers who engage in very high-risk projects are willing to borrow at high interest rates. If projects succeed they get windfall profits, as they know that when projects fail, the loss is shared between the bank and the borrower. There is information asymmetry between the borrower and the lender. The borrower knows his probability of paying back the loan while the lender does not. The borrower may even plan to default on a loan and the lender may not know this. This is the 'adverse selection problem'.

There is also a moral hazard problem in the sense that after getting the funds the borrower may engage in actions, which do not enhance the chance of repaying the loan. The banks do not have the information about how the borrower will manage the funds and cannot include sufficiently an implicit cost of default, as it will be unfair for the good borrowers who have intention to pay back the loan and who do not engage in speculative business.

Thus high interest rates increase the adverse selection and moral hazard problems in two ways. First borrowers engage in projects with high returns but risky ones in order to repay the loan. Secondly, the greater the interest rate, the higher the incentive for the borrowers to default. After all it is the risky oriented bad borrowers who are willing to borrow at higher rate of interest than the limit. Hence liberalization of interest rates does not eliminate the capital rationing situation as lenders fear increasing interest rates beyond a certain limit to match supply and demand for loans.

Experience from several countries show that as a result of interest rate liberalization, interest rates rise to very high levels forcing credit worthy customers out of the loan market and attracting risky loving borrowers. Weak Bank supervision compounds the moral hazard problem as well, resulting in large non-performing assets as a result of bankruptcies and unwillingness to pay back. A number of countries also liberalized interest rates in an inflationary environment. This led to high interest rates. Turkish experience shows that economic stability is required to improve the efficiency of credit allocation. The importance of sequencing and timing is highlighted below.

Another consequence that arises from changed bank behavior towards risk is a change in banks loan portfolio. There is preference of short-term lending and public sector debt instruments. Bank credits are channeled to consumer loans and trade finance instead of true investment finance, There is also a bias against financing the risky agricultural sector. Therefore interest rate and financial liberalization in general particularly in an inflationary economic environment may lead to inefficient credit allocation. Tanzanian experience described above is consistent with this theoretical perspective.

Financial liberalization in Tanzania led to very high lending rates, encouraging risky borrowers and thus discouraging banks from lending to risky borrowers. Often, sectoral allocation was also in favour of short-term speculative and low risk sector ignoring certain risky sectors like agriculture and micro-enterprises. This may indicate increased risk on the part of the banks to make loans in the face of increased asymmetrical information caused by the increased lending rates after the liberalization period when compared to the period before liberalization. Banks and good credit worth borrowers are reluctant to participate in the high credit risk sectors like trade finance and agriculture. Trade finance has high risks because of high standards expected of exporters. Agriculture by its nature is also inherently risky.

The lending rate has significantly increased during the period 1992-1996 in spite of entry of several new banks. This shows the reaction

of the banks to the asymmetrical information problem as they are forced to compensate for increased risk and it may also indicate lack of competition in the banking system. Besides the asymmetrical information problem we also need to address ourselves to how the reform process was managed in Tanzania as it also has impact on the reform process as hinted above.

Timing and Sequencing of the Reform Program

Allawode and Ikhide (1997), Montiel (1996), Villanueva and Mirakhor (1990 and World Bank (1989) show how financial liberalization may lead to traumatic economic conditions and the reasons for the financial crises. They warn that Financial sector liberalization should not be seen as an immediate removal of all existing controls on financial institutions. "Grave errors in the timing, sequencing and speed of financial reforms" lead to these crises. The need for prudential regulation and controls is also emphasized.[7]

Unless stabilization of the macro-economy precede financial liberalization, financial liberalization results in increased interest rates which make debt servicing impossible. Without a viable tax collection system, governments may be forced back into inflationary financing. The resulting macroeconomics instability induces distress borrowing. This problem may be compounded by weak bank supervision and ineffective regulatory framework. The right sequencing and timing of the reform program recommended is as follows.

Firstly is the timing of financial reforms. Stabilization must precede the reform effort. This relates to commencement of financial liberalization vis-avis other components of the structural adjustment process. Market liberalization and macroeconomics stability should be in place. Those countries with economic instability should liberalize gradually. If this is not followed distress borrowing, sharp increase in interest rates and loss of monetary control results.

Secondly we must pay attention to sequencing of the reforms. This is the order in which the financial liberalization package should be given. First prudential regulation is revamped followed up by restructuring or liquidating distress financial institutions. Strengthening prudential regulation and controls relates to capital adequacy requirements, criteria for new banks to register and activities allowed. Country experiences with financial liberalization is mixed due to failure to observe proper sequencing of the reform process. Weak ones must be strengthened. After this market based instruments of financial controls on interest rates and credit need to be abolished.

Finally, the speed of the reforms is yet another consideration. Experience of interest rate liberalization and financial liberalization in general in developing countries show that the process has failed or succeeded depending on initial conditions, capacity for regulation and supervision and strategy used for the reform program. The whole structural adjustment program in Tanzania came late and financial sector liberalization was implemented at a time when inflation was high. This necessitated high lending and deposit rates that were not sustainable after 1997. Because of this, initial conditions were not good. Prudential regulation and overall management of the economy was probably not strong enough as this capacity takes a long period to build. The tax system was weak but did not result in inflationary financing because of over dependence on donor funds. This problem was later addressed. Market and trade liberalization preceded financial liberalization

As already stated, Tanzania started financial sector liberalisation in 1991 at a time when inflation was high and the capacity to manage it effectively was still inadequate. This situation was compounded by existence of a cheap

[7] Timing and sequencing of structural adjustment policies has been discussed many. Allowade and Ikhide is perhaps one of the most recent articles on the subject

deposit insurance policy. It is these conditions which precisely led to failure of the Meridian Bio bank.

However, we benefited from experience of successful stories and failures elsewhere and so managed to avoid some mistakes of the pioneers. Market and trade liberalization preceded financial liberalization and financial liberalization was gradually introduced. What might have been a problem was in the area of effective supervision and regulation to ensure low spreads between deposit and lending rates in order to encourage savings and lending to priority sectors. One tends to see the lending rates as too high when compared to expected returns and risks of borrowers. Unless inflation continued to fall equilibrium could have been difficult to attain. We don't find any problems in the sequencing of the reform program as market liberalization proceeded the financial liberalization phase.

The other main problem relate to structural and institutional rigidities in the economy. Unless serious measures are undertaken to address this problem financial integration is not possible. Financial markets remain fragmented and oligopolistic. The formal and informal financial markets are not linked together to reinforce each other. The new banks tend to be located only in DSM and several branches in the country have been closed living a vacuum to be served. Other distortions include high reserve requirements imposed on the banks in the 1990s.

CONCLUSION

While the financial liberalization school expects lending rates to equilibrate the supply and demand for loanable funds, the new institutional school negates this argument on the basis of asymmetrical information problems. In Tanzania during the period 1991-1995, the deposit rates and lending rates were high. This phenomenon could not be sustained. Both rates had to fall particularly due to response in fall of interest rates for government securities. Positive responses observed were more credit to the private sector and an increased proportion of time and savings deposits as compared to demand deposits although the currency ratio continued to increase during the period.

Overall, we find that the asymmetric information problem has played role in the Tanzanian economy during the 1991-1997 period. This manifested itself mainly in the reluctance of the banking system to lend to the private sectors favouring risk free lending to the government sector in the form of government securities. The agricultural sector has also been marginalized when compared to 1970s situation. This is not conducive to development in so far as this sector is the backbone of our economy. We do not find major problems in sequencing, timing and speed of the reform process. However, the degree of regulation and supervision as well as the state of macroeconomics stability might have been influencing factors.

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SOCIO-ECONOMIC IMPACT OF PRIVATISATION: THE TANZANIA EXPERIENCE

*Adam M. Mwandenga**

Abstract: In Tanzania and during the short run period privatisation has had both positive and negative effects to the economy. The positive impact seems to outweigh the negative. Positive divestiture results can be measured by the number of firms that have been divested, performance of firms which have already been divested, performance of firms, particularly those involved in the supply of public utilities which for the time being remain in the public sector domain, and the degree of competition enhanced by privatisation in general. Negative divestiture results seem to hinge primarily on the number of retrenchees. This factor call for further research to quantify the exact amount of loss of job opportunities, since there are cases where divestiture led to an increase in job opportunities. Indeed there are also cases where some of the retrenched were redeployed.

INTRODUCTION

Privatisation is the act of reducing to role of government, or increasing the role of the private sector in an activity or in the ownership of assets.[1]

Given the severity of poverty and the pace of population growth, most low-income countries have no choice but to accelerate economic growth if they are to provide new job opportunities and reduce unemployment. The respectable Gross Domestic Product (GDP) growth rates of successful performers in Sub-Saharan Africa are not enough to make a serious dent in poverty - or to generate enough new, productive jobs, to replace those that may be lost initially through privatisation or civil service reform. With population increase of 3 percent a year, GDP growth of 4 to 5 percent means per capita increase of only 1 to 2 percent. At this rate, it would take low-income countries more than half a century to reach the living standards of today's middle-income countries.[2] Tanzania's Development Vision 2025 envisages a catch-up with middle-income countries by the year 2025.

In addition to slower population GDP growth of 7-8 percent in real terms - with the benefits shared widely - is needed to reduce significantly the number of people living in absolute poverty below the current level of one billion. Rapid growth is also needed to maintain harmony among different groups competing for their share of the economic pie in increasingly pluralistic political systems.[3]

Needed now are stronger actions to reform public enterprises and faster and deeper programs of privatization to produce macro-economic improvements through major reduction in fiscal deficits and general improvement in business conditions. Simultaneous action is needed on both fronts - public enterprises reform and privatisation are not "either or" propositions.[4]

Rationale for Privatisation

Privatisation programs often cite a laundry list of objectives, including reducing the fiscal deficit, raising revenue through asset sales, generating additional

* Lecturer in Economics and Finance, Department of Professional Accountancy, IFM, Dar es Salaam. This paper was originally presented at TAA seminar, 15 th July 1999 in DSM

1 Savas E. S., 1987: 3

2 Wolrd Bank, 1995

3 *Ibid*

4 *Ibid*