

FINANCE AND DEVELOPMENT IN TANZANIA AND POLICY IMPLICATIONS FOR RURAL DEVELOPMENT BANKING

F. Rubara

INTRODUCTION

The rationale of development banking and its attendant supply-leading concept has a theoretical under-pinning in the relationship between finance and development. This is to say that finance leads and causes development. Patrick (1966) defined supply-leading finance as the creation of financial institutions in advance of demand for their services in an effort to stimulate economic growth. Development of the financial services precedes demand for their services and economic development. Development banks were started in the 1960s and 1970s in developing countries as supply-leading finance institutions to offer finance in anticipation of development in order to resolve a perceived market failure particularly in the rural sector. The UN development decade of the 1960s was possibly responsible for their birth. Their role was to provide medium and long-term finance as well as being able to carry out promotional activities related to development. They were also often aimed at poverty alleviation.

STATEMENT OF THE PROBLEM

Indeed, many developing countries have placed a great deal of emphasis on financial development assuming a supply-leading role. Whether financial development in its own right can have a causal effect upon economic growth, or in other words if it is theoretically and empirically correct to say that financial development is supply-leading, is a contentious issue among development economists as will be evident from the literature review below.

There is an opposing school of thought which believes in finance being demand-

following. This asserts that finance is passive in the development process and therefore should be provided where there is already a demand for its services. In other words we assume that development should be seen only as a consequence of the real side of the economy. There are numerous influential economists who also believe that finance is a relatively unimportant factor in economic development. Other economists find it to be neutral and even a few suggest that the direction of causation changes overtime.

In spite of these divergent views, policy and practice in the 1960s and 1970s assumed a supply leading role. Both donors and governments shared this vision particularly resulting from World Bank development strategy regarding the poor and the UN decade of the 1960s. The stable financial and economic climate at the time was conducive to the implementation of this philosophy. The current emphasis on financial liberalisation by the financial sector also assumes a positive relationship between financial and economic development.¹ Without that relationship resources would only be used in productive areas of the economy.

However, the supply-leading philosophy of development banks and more precisely its attendant cheap interest rate policy that was pursued has failed to achieve its intended objectives in almost all third-world countries where it was tried. The question that arises from this failure is whether the supply leading finance is a sound development theory. To resolve this problem, we need first to test whether there is a significant relationship between finance and

¹ See Clarke and Dann

development. Secondly, there is also the need to account for the failure of development banking in order to find a positive relationship, as rhetoric has not matched experience in this field.

Research Questions

There are a few studies, some based on a group of countries in a given period and a few of them on individual developing countries, that have tried to resolve these issues. Unfortunately, hardly any study has attempted to shed light on this question using Tanzanian data. This research is a modest attempt at filling this gap using correlation analysis and a theoretical discussion on the role of the financial system in economic development. An ambitious and perhaps more accurate means of capturing causation using sophisticated modeling techniques such as the Granger econometric method will be attempted in future.

The main hypothesis to be tested is:

HO: There is no relationship between finance and development. Our belief is that there is a positive relationship. We would therefore need to minimise the type 1 error of rejecting a truly null hypothesis.

H1: There is a relationship between financial and economic development.

Although there is no unanimous agreement on the supply-leading philosophy, most of the evidence suggests a positive relationship.

Secondly, this positive relationship is also theoretically investigated through a discussion the role of the financial system and is implicitly assumed in the emphasis on financial liberalisation as already stated above. If it can be established that finance causes development, it may be ill-advised to close bank branches unless alternative ways of supplying financial services is developed. This is therefore an important research problem for Tanzania in this era of financial liberalisation and emphasis on poverty reduction.

The third consideration regards the policy and implementation problems that may have hindered the success of the supply-leading philosophy. If indeed supply-leading finance is conducive to development, the causes for its dismal performance must be highlighted so that past mistakes can be avoided.

Empirical Literature on Financial Development and Economic Growth

The 1920s depression was believed to result from the behaviour of the financial system. The macroeconomics literature following the Keynesian economic system by focusing on money however, shifted the emphasis from direct causation to one of indirect relationship. It was Gurley and Shaw (1955, 1967), Goldsmith (1965, 1969) and Patrick (1966) who redirected the focus onto financial development and development by stressing the role of intermediaries in the credit supply process in contrast to the money supply process. Another earlier writer sharing the supply-leading role was Galbis (1977, 1982). Recent literature includes Gupta (1984), Jao (1986), Jung (1986), Greenwood and Jovanovic (1990, 1998), Bencivenga and Smith (1991), King and Levine (1993), de Gregorial Guidotti (1995) and Clarke and Danna (1997).

Patrick (1966) helped to lay bare the supply-leading and demand-following philosophy cited above.²

The promotional role of development banks derives from this Patrick Philosophy. Development banks became specialised institutions providing a whole host of promotional services ranging from project identification and appraisal to the supervision and management of enterprises they finance. In developing countries, where there are few entrepreneurs, development banks assumed this

² See Patrick (1966) pp. 50-52 for more explanation of the supply-leading and demand-following concepts.

role. They undertook risky enterprises in the form of venture capital and created industries and financial services well in advance of demand to stimulate development. They did sector studies and provided advisory services to government in the same spirit of development. They also established enterprises which would later be sold to entrepreneurs and participated as boards of directors in projects they financed to demonstrate their entrepreneurial initiative. Patrick (1966) did not view supply-leading finance as a necessary condition or precondition for economic development to take place. He merely thought that supply-leading finance could induce development. However, as development proceeds, he believed the supply-leading role of financial development diminishes gradually and is eventually dominated by the demand-following response. The majority of authors believe in this supply-leading philosophy but there are other schools of thought.

A consensus appeared to have been reached by the mid 1970s on the relationship between financial and economic development. McKinnon (1973) and Shaw (1973) in their separate works made a great contribution to this debate. McKinnon argued that investors in developing economies had limited external finance and self-finance. Hence, because investment expenditures were lumpier than consumption expenditures, potential investors had first to accumulate financial assets before investing in physical assets. Therefore, according to McKinnon and Shaw, any financial policy like financial repression that kept returns on financial assets low discouraged capital investment thus hindering economic development. This financial liberalisation school therefore called for the liberalisation of the financial sector to provide for financial deepening leading to economic growth.

Shaw, on the other hand, emphasised the role of interest rates in savings mobilisation and financial development. With higher deposit rates, the volume of financial savings increases with

the enhanced incentive to save. The financial institutions are then able to increase the efficiency of investments, reduce transaction costs, minimise risk and develop economies on the scale indicated above. Both McKinnon and Shaw therefore decried the use of financial repressive policies. An additional contribution was made by Galbis (1977, 1982) who emphasised the impact of financial repression on the quality and quantity of total investments. Financial repression tends to encourage self-financed investments at the expense of intermediation and borrowing as it lowers the incentive to save. The resulting credit-rationing situation also discriminates against new enterprises and entrepreneurs by favouring those borrowers with security and a good track record.

Notwithstanding the contributions of these theorists, there were two weaknesses in this economic literature. First, as already been stated above, the methodological revolution in macroeconomics of the 1970s had diverted the attention from the main question of financial and economic development to other issues which were indirectly related. The debate was focused on interest rates and on the complementary hypothesis that links accumulation of money balances (financial assets) with physical capital accumulation. An increase in interest rates induced more savings that, *ceteris paribus*, enable capital investments to take place. This complementary hypothesis assume that personal savings were limited and that capital investments required prior accumulation of capital. Indeed it is Patrick (1966) who had focused on the main question at stake. Secondly, empirical investigation on the important question of financial and economic development was lacking.³ Granger's (1969) econometric method later proved to be a useful tool in studying this empirical relationship.

³ This is reported by Odeducum (1996)

The empirical works supporting the supply-leading view, from Gupta (1984), Jao (1985), Jung (1986), Gregorio and Guidotti (1995), and Gupta (1984) on 14 developing countries and Jung (1986) on 37 developing countries and 19 developed countries, used the Granger testing theory to study this causal relationship. Their results supported the supply-leading philosophy. Jung's analysis applied causality analysis using time series data on M1 and M2 as financial development indicators and per capita GDP as indicators of economic growth. The ratio of M2 to GDP was used as proxy for the degree of monetisation in the economy. Recent studies by Clark and Danna (1997) and Greenwood and Jovanovic (1998) have used similar approaches in their empirical investigation. Greenwood and Jovanovic (1998) assert that financial development makes a higher return on capital to be earned and the resulting increased growth then allows costly financial structures to be implemented. In this way financial development and growth are completely linked together.

Jung's (1986) econometric evidence shows that causality may be in either or both ways. This two-way causation was also found by Greenwood and Jovanovic (1990). Economists who believe in a neutral or passive relationship. Include Guley and Shaw (1967), Goldsmith (1973), Woolmer (1977) and Lucas (1988). This school of thought suggests that financial development follows rather than leads economic development and their belief is shared by a minority of authors. Lucas for example feels the relationship is over-stressed.

Anthony Wood (1993) made an empirical investigation into the direction of causality of financial development in Barbados applying Granger causality testing and found a bi-causal relationship for the data of 1946-1990. When he divided the data into two sub-samples, 1946-1968 and 1969-1990, he found financial development to be demand-following for the former period and supply-leading for the latter.

It should be remembered that Patrick (1966) had argued that the supply-leading role would dominate at lower stages of development and become demand-following at higher stages of development.⁴

Our study is modeled along the lines followed by Clerk and Danna (1997), King and Levine (1993) and Greenwood and Jovanovic (1998). These studies correlated indicators of financial development with indicators of economic growth. They differed from much earlier studies of this sort by taking broad money (M2) instead of M1 and by looking at the correlation among several ratios instead of concentrating on one. Their results support the supply leading phenomenon.

The ratios used are:

i) Monetisation Ratio = Broad Money/GCP

Correlation with an economic development indicator indicates the supply-leading phenomenon.

ii) Domestic Assets Distribution Ratio

Examined as proportion of total domestic credit and GDP and Credit issued to the non-financial sector firms to Total credit or as a ratio to GDP.

These two ratios give good indicators of financial deepening, as the private sector is more efficient in its allocation of resources when compared with the public sector. The credit to banks is excluded.

iii) Financial Institutions Ratio

$$= \frac{\text{Deposit money banks Domestic Assets}}{\text{Total Bank domestic Assets}}$$

⁴ For surveys of empirical literature see Kitchen (1986), Gregorio and Guidotti (1995), King and Levine (1993) and Odedokun (1996)

This indicates the importance of deposit banks in total bank deposits.

THEORETICAL AND EMPIRICAL RELATIONSHIP BETWEEN FINANCE AND DEVELOPMENT

The causal relationship is implicitly suggested or theoretically easily conceptualised when we examine the functions played by any financial system. These relate to resource mobilisation, intermediation, maturity transformation, risk transfer, reduced transaction costs and its role in solving an asymmetric information problem.⁵ A number of empirical studies have also been done elsewhere to establish the relationship between finance and development. This section starts with a theoretical discussion on the role of the financial system and then conducts empirical work on the subject.

The Financial System and Economic Development

The traditional economic literature seemed to recognise the importance of the financial system in real economic activity. In 1911 Joseph Schumpeter argued that the services provided by financial intermediaries (promotional activities) of mobilising savings, evaluating projects, managing risk, monitoring managers and facilitating transactions are essential for technological innovation and economic developments.⁶

At any one moment there are people who have idle funds or savings who do not wish to invest them in a productive venture, because of the risks. At the opposite end of the scale there are others with deficit finance but with viable productive projects who are willing to take risks. The role of savings mobilisation is that

of persuading those with surplus funds to deposit them with a financial intermediary for a return. Without financial intermediaries these funds would be idle.

The essence of intermediation is where a financial institution acts as a middle-man between surplus and deficit units. The financial markets then become an indirect means of linking savers to borrowers. Without these institutions, each borrower would have to search for persons with surplus funds. Alternatively, the borrower will have to depend on personal savings. Savers who do not wish to invest will have incentive to save. They will engage in conspicuous consumption. To throw more light on why financial intermediaries are necessary, we need at this juncture to discuss their role in reducing transaction costs, diversifying of risk and dealing with asymmetrical information problems.

Financial intermediaries have their costs, so they have to justify their existence. One of the critical dimensions is their role in reducing transaction costs. How is this done? Two ways in which this is made possible is through economies of scale and development of expertise to lower transaction costs. Average total costs normally decline as the size of transactions increase. A direct link between a saver and an investor would involve higher average costs when compared with a situation where an intermediary bundles many sources of funds together. This is the concept of economies of scale. They also hire legal expertise to enforce contracts thereby lowering the cost per transaction with compared a situation where each saver would need to hire this costly expertise. Related to the issue of reduction of transaction costs is when they hiring of employees to assess and monitor projects to avoid adverse selection and moral hazard problems.

Asymmetric information concerns inequality of information between the financial intermediary, or the individual saver who wants

⁵ We have relied on Getler (1988) and Patrick (1966) for discussion on the role of financial systems.

⁶ This is derived from King and Levine (1993)

to lend money, and the borrower. The borrower has more information about the project he wants to invest in and his willingness to pay than the lender. Speculative investors borrow money for high-risk projects but hide this information, as they know these projects would not be approved. Borrowers who are unwilling to pay back often portray themselves as the best creditworthy customers and are the most willing to borrow when interest rates are high. Financial intermediaries are more well-placed to deal with this problem than individual clients, as they are able to acquire information in many ways at reduced cost. This information may be acquired by forcing borrowers to have accounts with banks and through co-operation with the banks that to know the credit history of the customers concerned.

This information problem on the part of financial intermediaries is two-fold before the project is approved and after. The adverse selection problem which occurs before the event is when those who are mostly likely to be bad customers are mainly the ones who seek the loan and who are most likely to be selected. It is this problem which creates a credit-rationing situation at high interest rates. The moral hazard problem, on the other hand, occurs when the lender is subject to the hazard of the borrower engaging in other activities which were not approved and which often are very risky (hence immoral) and therefore reduce the probability that the loan will be repaid. Because of this problem lenders may decide not to give loans.

Again financial institutions are well placed to deal with the adverse selection and moral hazard problems. The former is tackled through project approvals, the necessity for borrowers to offer collateral security, a mandatory proportion of equity capital in the project financed, gathering of information on clients, mandatory deposit accounts and government guarantees.

The moral hazard problem is compounded by the principal agent problem that would not

occur if no asymmetry of information existed between owners and managers. Managers have more information than their owners about the enterprises they run and often can even ensure that decisions are passed that benefit the enterprise at the expense of the firm or their owners. It is therefore imperative that financial intermediaries and owners think of ways of reducing this moral hazard problem. This is accomplished through project monitoring (visits and progress reports) government regulation to increase information, i.e. accounting data, representation of financial institutions as directors on the boards of projects they lend to, debt contracts and enforcement of loan covenants.

The question of Maturity Transformation is one of changing short-term finance into long-term finance. Most savers like to entrust their funds to intermediaries for a short period of time and be able to withdraw some of these funds at short notice. Mainly because of the confidence they have in intermediaries, they never withdraw all their money. With experience the intermediaries then know what proportion of funds are necessary to meet the liquidity of their clients. They can therefore lend the rest of the funds for long-term investments. On the other hand most borrowers require funds for long-term investments. Without the availability of these intermediaries, they could only invest in short-term speculative projects using short-term funds from individual savers.

The issue of risk transfer is also a critical ingredient to savers who are unwilling to take risks in lending money to individuals. Financial intermediaries on the other hand try to diversify the risk from clients they lend to through acquiring collateral and guarantees. They also have the knowledge and legal power to sue their clients at lower cost. Through loan covenants they are able to reduce the cost of loan default. They may also apportion the risk between the borrower and themselves through equity participation and differential interest rates.

As we have already stated these institutions also have expertise in project appraisal. They are better able to scrutinise projects and allocate funds to priority and profitable projects. This efficient allocation of resources which otherwise would not have been generated leads to faster economic development. It is in this sense that we may suspect a causal relationship running from financial development to economic growth and development. We could also add the supply-leading role of development banks as yet another key development function. Development banks pioneer in areas where as yet no demand exists for financial service. They provide the entrepreneurial role that is vital in underdeveloped environments. They undertake risky ventures to bring about development and may address themselves to solving the social and economic imperatives of the day with regard to poverty reduction, redistribution of income, foreign exchange and savings generation objectives not motivated purely by profit.

By deduction, therefore, we can confirm the developmental role of the financial sector and of development banks in particular. However we must be aware that financial development is only one of the ingredients in bringing about development. Other generally understood inputs such as factors of production are involved. However, finance in most of the development literature of the past was ignored as a key input. Moreover, there are currently those who think that finance plays a passive role. They see it as demand following. We can only demonstrate the causation empirically.

EMPIRICAL INVESTIGATION

We start first by looking at a table of one indicator of financial development, one source of growth and GDP growth itself before undertaking a correlation analysis of some selected indicators along the lines of the above-mentioned studies. We use M2/GDP as a measure of financial deepening and Investment/GDP as a source of growth.

Table 1: Financial Development and Economic Growth (% of GDP)

YEAR	Real GDP Growth	M2/GDP	Investment/GDP
1989	-3.9	20.0	19.3
1990	5.4	21.5	28.2
1991	4.5	20.8	28.5
1992	-8.9	22.3	29.0
1993	12.2	22.8	26.7
1994	1.4	22.9	26.4
1995	2.6	21.9	21.2
1996	4.1	19.8	18.0
1997	4.0	17.7	16.2
1998	3.4	17.3	16.1

Source: African Indicators 2000 and Bank of Tanzania Economic and Operations Report June 1999, M2/GDP ratio was computed.

Tabular Analysis

The table does not show any easily-seen relationship between financial indicator M2/GDP and growth. Thus whereas M2/GDP ratio has been increasing between 1989-1991 the GDP growth rate has fluctuated. The M2/GDP rate however seems to have a positive relationship with the investment/GDP ratio. Overall, we may suspect some positive correlation between financial indicators and growth indicators.

When compared with other developing countries at a similar level of development the M2/GDP ratio indicates a low level of financial development. This has implications for financial savings mobilisation, resource allocation and efficiency of investments. According to the financial liberalisation thesis, this would imply that financial sector liberalisation has not greatly improved the situation.

Correlation Analysis

We use only one development indicator, namely the ratio of Investment to GDP to test our hypothesis of the relationship between finance

and development, due to lack of other indicators like GDP growth and GDP per capita growth for the whole period on a consistent and yearly basis. We also believe these other indicators are influenced by many factors. Our statistics derive from the IMF year book. We use M3 instead of M2 and had to deflate the monetary figures before dividing by real GDP from the IMF year book. The computed figures are given in the appendix to this paper. The data ends in 1996 because of the change in the base period for the price deflector in the IMF year book.

A correlation matrix was computed from the time series ratios in the appendix. This gives the interrelationship between the financial indicators and development indicator. The results were as follows.

Table 2: Correlation Matrix

	Rm3	Dmbdar	Cpsr1	Cpsr2	Ir
Rm3r	1.0000	0.6795	-0.5854	-0.5068	0.1825
Dmbdar		1.0000	-0.4794	-0.4528	0.0953
Cpsr1			1.0000	0.8305	0.2161
Cpsr2				1.0000	0.1914
Ir					1.0000

An examination of the correlation matrix shows a positive association between the financial indicators and the economic development indicator of investment ratio. We can therefore suspect that financial development causes investment to take place leading to economic development. Correlation analysis between the financial indicators is positive except for credit to the private sector ratio. This is probably due to lack of emphasis on the private sector for most of the period. We can test the hypothesis that the correlation coefficients are significantly different from zero using $t = r\sqrt{(n-2)/(1-r^2)}$ where r is correlation coefficient.

The hypothesis to be tested is:

HO: $\rho = 0$

HI: $\rho \neq 0$

$t_{\alpha} = 2.086 \alpha = 0.05$

This gives the following statistical results:

Table 3: Significance of the Correlation Coefficients with the Development Indicator

	Investment ratio	Comment
RM3	.18248 (0.830)	Insignificant
DMBDA	.09533 (0.4283)	Insignificant
CPSR1	.21618 (0.990)	Insignificant
CPSR2	.19138 (0.872)	Insignificant

Key:

Rm3 = Ratio of broad money to GDP

DMBDA is domestic money bank domestic assets ratio

CPSR1 is credit to private sector as proportion of total domestic assets and

CPSR2 is credit to private sector as proportion of GDP.

All the t values are not statistically significant at 95% confidence level. This confirms that the correlation between financial indicators and development indicator is not significantly different from zero. We fail to reject the null hypothesis. There is no strong evidence that finance leads to development from our results, although there is a positive non-significant relationship. This result, plus the belief in the supply-leading phenomenon theoretically justified by our discussion on the role of the financial system in development, makes us suspect a positive causal relationship.

Correlation analysis is not a strong test however. The reverse could also be true. Correlation analysis among several variables is influenced by partial correlation between the

variables. Guidott (1995) has also pointed out the weaknesses of the financial development indicators. Financial aggregates like M1 and M2 are more related to liquidity than they are correlated to allocation or efficiency of investments. Most empirical estimates were done however with M2 and M1. We used M3 to minimise this problem.

PROBLEMS AND PROSPECTS IN RURAL DEVELOPMENT BANKING IN TANZANIA

If we agree that finance leads to development we can hardly belittle the important role of supply-leading finance. This is more so in the context of rural development banking. The rural sector is a very risky one. It has a poor communications and transport infrastructure facilities. The transaction costs involved in serving rural clients are huge due to great distances between bank branches and the location of clients. There is great uncertainty in the natural, economic and social environment affecting rural development projects. The vagaries of the weather, counter-productive policies environmental and the cultural beliefs that may be unsupportive of new technological changes have an impact on rural development projects. For all these reasons, commercial banks tend to shy away from operating in rural areas particularly when the focus is on micro-enterprises. It is rural development banks whose philosophy is focused on development rather than maximisation of profit that can help to induce rural technological change. Their promotional and entrepreneurial role ensures that this noble cause is achieved.

However, it is one thing to appreciate this important development role but another matter to ensure sustainability of services. In the past, too much emphasis was put on development at the expense of sustainability of the rural development institution. This is not sustainable development. In the 1960s and 1970s cheap funds were available from donors and government budgetary allocations for subsidies

to development banks were available. With the onset of the external debt problem and economic crises in developing countries, it was no longer possible to sustain the activities of development banks. They were now viewed with mixed feelings. What then were the key mistakes that were made? We hasten to say at this juncture that these mistakes have nothing to do with the supply-leading philosophy.

First is the important question of the lending policy of development banks. Subsidised interest rates have been justified by Keynesian economics. This philosophy came to be shared by governments and donors alike. Without elaborating on this issue, stylised facts have shown that concessionary finance does not lead to distribution equity nor is it an important inducement towards technological innovation. The policy also undermines the viability of credit institutions in the presence of high lending costs and default rates among large borrowers. East Asia succeeded with subsidised interest rates among other interventions because they were moderate and commercial criteria were followed where priorities had been identified. Given the fact that the agricultural sector is a risky enterprise, interest rates must reflect this cost for sustainable lending.

The failure to link savings with investment was an equally important factor. Inducement to save is enhanced by the promise of borrowing for future investment. Accepting deposits also avoids dependence on government and donors for funds. Moreover, deposits can act as a means of information and insurance to the lending institution. In the process of accepting deposits we get information on the credit rating of the customer and we can treat some of the deposits as insurance for repayment of the loan. There has been also a tendency in lending for approving projects on basis of collateral security offered instead of project viability. However, it is almost impossible to recover loans from collateral security because of the difficulties involved in enforcing legal contracts. Finally is the failure

of lending policy to find cheaper means of delivering credit. Financial fragmentation has worked to the detriment of our development banking institutions.

Secondly, government intervention has in many ways contributed to poor performance. Price and exchange rate policy has often been unsupportive of agriculture. It has reduced the price margins of farmers thereby contributing to failure to repay the loans. We have tended to their replace markets instead of using them. Political pressure to finance bad projects was not uncommon. The failure to improve or maintain existing infrastructure does make marketing and distribution of commodities difficult thereby contributing in a loss particularly to perishable products.

Thirdly, sources of funding have influence on the autonomy of decision-making and sustainability of the funding. Over-dependence on donor and government funds may entail loss of autonomy of the institution's management and sustainability becomes difficult in the presence of budgetary restrictions and withdrawal of donor funds. It also becomes difficult to maintain an even level of operations without its own funds. Again there is a tendency for directives on branch expansion in places where cheaper means of servicing these areas are available (i.e. informal and NGO network). There is the further problem of underestimating the real costs in external funds. As Harvey (1983) has shown, there are many hidden costs of external finance. A nominal interest rate is just one consideration. Other factors like repayment period, grace period, bureaucracy in approval of the loan, costs of tied aid and so on are of equal importance. Soft loans are not cheap when examined in this context. Moreover, even if these funds are really concessionary, they should be lent out at their opportunity costs in the economy for efficient resource allocation.

Last but not least, is the essence of regulation and control. Where there is government intervention one cannot expect strong regulation

and control. Managers cannot be held accountable when they are being directed from their parent agencies to act contrary to their beliefs. Professionalism was lacking and capacity for regulation and control was weak. Government policy also did not quickly adapt itself to failure and changing circumstances. This is why concessionary finance and a high degree of non-performing assets persisted.

The 1980s in Tanzania were characterised by inflationary pressures resulting from the different forces affecting macroeconomic instability. The external environment was also hostile. The debt problem hiked up interest rates in the international financial markets increasing the cost of borrowing. World recession meant lower prices for our exports. Devaluation increased the cost of imports. Serious government budgetary deficits forced the cut in subsidies. At the same time those responsible for the repayment performance of the development, as well as donors who had the same vision for the important role of development banks, had to rethink a new development strategy for development banks.

The mistake provides key lessons for successful development banking. The leading policy of development banks must reflect both the costs of finance and the high transaction costs of rural development banking. Concessionary finance is not the solution as interest rate is not the major item of cost. Where we are forced to offer concessionary finance, moderate subsidies must be seen in the light of performance criteria of efficiency. The most credit-worthy clients must be selected as an incentive to economic efficiency. Co-financing of development bank projects by private banks will also tend to encourage the use of efficient economic means. Savings mobilisation has in the past also been forgotten half as none of But they was engaged in deposit mobilisation. Tanzanian development banks have now already adopted universal by mixing development banking with commercial banking and savings mobilisation is high on the agenda.

Transaction costs and risks can be dealt with in several ways. There are credit delivery innovations such as the Grameen banking that have been a success story elsewhere which are being tried in Tanzania. Financial integration through linkage of informal finance institutions and NGOs with formal financial can significantly reduce costs. However, these institutions need to be strengthened first as they are currently weak. They provide a cheaper means of delivering credit and have a deeper knowledge of the credit-worthy and risky clients they serve. Linkage with product credit markets also reduces transaction costs and risks of loan default. Cooperatives and private sector initiatives in marketing and distribution of goods and services can be relied upon for delivery and collection of loan arrears, reducing transaction costs and ensuring timely repayment. Through improvements in communication and transport, transaction costs and risks in rural areas can be significantly reduced.

We can hardly emphasise enough the need for independence of the banks from government intervention. Lending should be dictated by the viability of projects and not the desires of politicians. Once priorities are set, commercial criteria must prevail over political wishes. A supportive macroeconomics policy as highlighted above is essential. Where government fails, due to lack of resources, community participation as, for example, in improving transport and communications can make a big difference. Effective regulation and control by the central bank by way of capital adequacy requirements, deposit insurance and other instruments is essential for success. With all these policy scenarios we are optimistic that rural development banking can move ahead with considerable strength.

While arguing for the independence of banks, we are by no means negating the role of government in development banking. Market failure problems will always tend to occur. Thus in Tanzania, while several banks have started

operations, none has opened up branches in the rural areas. It is up to government to provide incentives to influence the location of these financial services. Special funds need to be created and made available to development institutions like NGOs to assist under-privileged groups and needs to be assigned this role to development banks. Development banks are not charitable organisations. They are development institutions focusing on economic and financial viability.⁷

CONCLUSION AND RECOMMENDATIONS

The main theme of this paper was the relationship between financial and economic development. We have used correlation analysis to test this hypothesis. Correlation may not necessarily indicate a casual relationship, but from the theoretical perspective we have established that this causal relationship runs from financial to economic development. There is no unanimous agreement on this conclusion but we have said that most authors lean more towards supply-leading finance when compared with demand-following or neutral perspective/two-way causation. Unfortunately our test cannot establish the direction of causation and does also have inherent weaknesses. We have also failed to observe a significant relationship between finance and development. But we have found a positive correlation. In spite of these remarks and other weaknesses cited in the paper, from our theoretical discussion and modest empirical work, we suspect a positive and significant relationship between finance and development. We believe our conclusion can be confirmed by use of more refined techniques such as the Grangerian testing and hence allude to the supply-leading philosophy.

This conclusion strengthens the case for supply-leading finance/rural development

⁷ Some of our views have been borrowed from Stiglitz and Uy (1996) in their explanation of Asian miracle.

banking. This is of prime importance at this juncture when market forces are having an upper hand in allocating our scarce resources. Government must take responsibility in this regard and must establish priorities within which development banks can apply commercial criteria and provide subsidised credit to institutions working with the poor to fill the vacuum left by development banks.

We have outlined the problems of rural development banking in Tanzania. Therefore we know that financial liberalisation *per se* is insufficient to lead to financial deepening. The policy options highlighted towards the end of the paper give us hope for successful rural development banking in Tanzania.

REFERENCES

- Bank of Tanzania (1999)
Operations and Economic Report June 1999.
- Clarke and Jovanovich (1997)
"Money, Finance and Development in Financial Evolution of the Caribbean Community" in Clarke L. and Dadds, L. (eds.) Caribbean Centre for Monetary Studies 1997.
- Galbis, V. (1977)
"Financial Intermediation and Economic Growth In Less-developed Countries: A Theoretical Approach." *Journal of Development Studies* 13(2).
- Gertler, M. (19)
"Financial Structure and Aggregate Economic Activity: An Overview." *Journal of Money, Credit and Banking*.
- Goldsmith, R. (1965)
The Flow of Capital Funds Into the Postwar Economy, New York.
- Getler, M. (1988)
"Financial Structure and Aggregate Economic Activity." *Journal of Money Credit and Banking* 20(3).
- Granger, C. (1969)
"Investing Causal Relationships by Econometric Models and Cross Spectra Methods." *Econometrica* 37(3).
- Greenwood and Jovanovich (1998)
"Financial Development, Growth and Distribution of Income." *Journal of Political Economy* 98(5).
- Greenwood and Jovanovich (1998)
"Financial Development, Growth and Distribution of Income." *Journal of Political Economy* xcvi.
- Gregorio and Guidott (1995)
"Financial Development and Economic Growth" *World Development* vol. 23 no 3.
- Gurley and Shaw (1955)
"Financial Aspects of Economic Development" *American Economic Review*, September.
- Gurley and Shaw (1973)
Financial Structure and Economic Development and Cultural Change, April.
- Gupta, K.L. (1984)
Financial and Economic Growth in Developing Countries: Croom Helm.
- Harvey, C.
Analysis of Project Finance in Developing Countries. Heinmann, London.
- Rodney, H.
"Stages of Banking and Economic Development:" *Savings and Development* no. 1, 1992 xvi.
- IMF, (1998)
Statistics Year Book.
- Jao, Y.C. (1976)
Financial Deepening and Economic Growth: Theory, Evidence and Policy.
- Jao, Y.C. (1985)
"Financial Deepening and Economic Growth: A Cross Section Analysis." *Malysian Economic Review* Vol. 7, No. 3.
- Jung, W.S. (1986)
Financial Development and Economic Growth: International Evidence of Economic Development and Cultural Change, January.
- King and Levine (1993)
"Finance and Development; Schumpeter Might be Right." *Quarterly Journal of Economics* vol. 108, no. 3
- Kitchen, R. L. (1986)
Finance for the Developing Countries: John Wiley and Sons.
- Lucas Robert (1985)
"On the Mechanics of Economic Development:" *Journal of Monetary Economics* vol. 22, no. 1
- McKinnon, R. (1973)
Money and Capital in Economic Development: Washington.
- Mishkin, F.S. (1988)
Financial Structure and Development: New Haven
- Naunde, W. (1994)
"The National Financial Accounts, Economic Growth and Development." *The Southern African Journal of Economics* Vol. 62, no. 1.

- Odedokun, M. O. (1996)
 "Financial Development and Economic Approaches for Analysing the Financial Sector in IDCS" *Journal of Development Economics* Vol. 50.
- Patrick, (1996)
 "Financial Development and Economic Growth in Underdeveloped Countries" *Economic Development and Cultural Change*, January.
- Roe, R. (1991)
 "Financial Systems and Development in Africa: A Conference Report," EDI World Bank.
- Shaw, E.S. (1973)
Financial Deepening and Economic Development: Oxford University Press.
- Stiglitz, J.E. and M.Uy (1996)
 "Financial Markets, Public Policy and the Asian Miracle:" *World Bank Research Observer* Vol. 11, No. 2.
- Wood, Anthony (1993)
 "Financial Deepening and Economic Growth in Barbados: Causal Evidence" *Savings and Development* 4(2)
- Woolmer, K. (1977)
 "The Financial System and Economic Development in Nigeria 1950-1971" in Newlyn, W.T. (Eds. *Financing of Economic Development*).
- World Bank, (1989)
World Development Report.