MONETARY POLICY STATEMENT
The Midterm Review

GOVERNOR
BANK OF TANZANIA

January 2005

January 2005

LETTER OF TRANSMITTAL

Dear Minister,

In accordance with Section 6 Subsection (1) to (4) of the Bank of Tanzania Act 1995, I hereby submit the mid-term review of the Monetary Policy Statement for the year 2004/05.

Yours sincerely,

The Hon. Basil P. Mramba (MP)
Minister for Finance
Dar es Salaam

Daudi. T.S. Ballali
Governor
Bank of Tanzania

CONTENTS

BANK OF TANZANIA'S INFLATION CONTROL STRATEGY

- *The primary objective of the Bank of Tanzania is **price stability**. The Bank therefore, has the responsibility of ensuring that it establishes monetary conditions that are consistent with low and stable inflation.*

- *Inflation control is not an end in itself, but rather, the means by which monetary policy contributes to overall economic performance.*

- *Low inflation allows the economy to function more effectively, thereby contributing to better economic performance over time.*

- *Central Bank control inflation by controlling the growth rate of broad money supply, M2, which is defined as currency in circulation outside banks, and total deposits held by commercial banks, excluding foreign currency deposits. M2 is chosen because it is the monetary aggregate that is estimated to have closest relationship with the rate of inflation*

- *To influence the rate of growth of money supply, the Bank of Tanzania targets reserve money, M0, which is directly related to money supply and is defined as the liabilities of a Central Bank, which include currency held outside the Central Bank and banks reserves held by the Central Bank.*

MONETARY POLICY IMPLEMENTATION

- *The Bank of Tanzania sets annual monetary policy targets in its Monetary Policy Statement at the beginning of every fiscal year. The targets are reviewed at mid-year.*

- *The Monetary Policy Statement is submitted to the Minister for Finance, who tables it in the Parliament.*

- *The same procedure is followed in the submission of half-year review of monetary policy implementation.*

- *The Monetary Policy Committee of the Board, chaired by the Governor, closely monitors monetary policy implementation on monthly basis.*

- *The Monetary Policy sub-committee discusses, on weekly basis, progress on monetary policy implementation and plans for the subsequent week.*

- *A Technical Committee, reviews liquidity developments daily, and agrees on market intervention strategies.*

THE MONETARY POLICY INSTRUMENTS

- *The Bank of Tanzania uses indirect instruments of monetary policy to influence the level of money supply.*

- *The main instrument is Open Market Operations (OMO). OMO involves the sale or purchase of securities, e.g. Treasury bills, by the Central Bank to withdraw or inject liquidity into the system, in order to influence the monetary base (i.e. reserve money).*

- *Other indirect instruments include Foreign Exchange Market Operations (FEMO), the discount rate, and the statutory reserve requirements.*

CONTROLLING THE RATE OF INFLATION

- *The objective of monetary policy is to achieve a low and stable inflation.*

- *The Bank of Tanzania focuses on the Consumer Price Index (CPI) as the measure of inflation.*

- *The Bank of Tanzania also monitors food supply and food price index. Food accounts for more than 50 percent of the average household expenditure (or the consumer basket) and food prices are sometimes influenced by non-monetary factors like drought and floods, which can affect overall inflation substantially, regardless of the stance of monetary policy.*

- *Inflation excluding rate of change of food prices is often referred to as NON-FOOD INFLATION (or Underlying Inflation), while the overall rate of change of CPI is referred to as the HEADLINE INFLATION.*

- *Thus, the non-food inflation is a measure of price movements, largely caused by policy factors, but frequently affected by external factors as well.*

1.0 INTRODUCTION

The primary mission of the Bank, as stated in Section 5 sub-section (3) of Bank of Tanzania Act, 1995 is "… to formulate and implement monetary policy, directed to the economic objective of maintaining price stability, conducive to a balanced and sustainable growth of the national economy of Tanzania". In other words, **it is the primary responsibility of the Bank of Tanzania to establish monetary conditions that will generate low and stable inflation over time**. Low and stable inflation enhances confidence in the value of money, which facilitates mobilization and allocation of resources in the economy. Currently the long-term policy objective is to achieve an annual inflation rate, which is close to the average rate of inflation of Tanzania's major trading partners including; Euro Zone, United Kingdom, South Africa, India, Japan, Kenya, United States of America, China and United Arab Emirates.

2.0 MACROECONOMIC POLICY FRAMEWORK FOR 2004/05

2.1 The Macroeconomic Objectives for 2004/05

The thrust of government economic policy objectives for the fiscal year 2004/05, is directed towards promotion of higher economic growth, strengthening poverty reduction, while consolidating and maintaining macroeconomic stability. The major macroeconomic objectives of the government for 2004/05 are:

i. To attain a real GDP growth rate of 6.3 percent during 2004 and 6.5 percent in 2005;
ii. To attain annual inflation rate of 4.0 percent by the end of June 2005.
iii. To raise domestic tax revenue to GDP ratio to 13.8 percent in 2004/05 from 13.3 percent in 2003/04, and maintaining the overall fiscal deficit at 3.7 percent of GDP.
iv. Maintain official foreign reserves at a level of about 7 months of imports of goods and non factor services

2.2 Monetary Policy Objectives for 2004/05

Monetary policy objectives of the Bank of Tanzania in support of the broader macroeconomic objectives of the government for the fiscal year 2004/05 are:

i. Containing the expansion of reserve money (M0) within a band of 20-23 percent between end-June 2004 and end-June 2005;
ii. Limiting the growth rate of broad money supply, M2 within a band of 20 to 24 percent and extended broad money, M3 (defined as broad money plus foreign currency

deposits), within a band of 20 to 23 percent between end June 2004 and end-June 2005;

iii. Attain an inflation rate of 4.0 percent by end-June 2005;

iv. Allow commercial banks credit to the private sector to grow by an annual rate of 34 percent by end-June 2005; and

v. Maintain an adequate level of foreign reserves to cover not less than seven months of imports of goods and services.

3.0 REVIEW OF MONETARY POLICY IMPLEMENTATION DURING JULY-DECEMBER 2004/05

3.1 Liquidity Management

A steady inflow of foreign assistance during the first half of 2004/05, coupled with HIPC debt relief, and an increase in exports resulted into considerable build up in liquidity and subsequent pressure in liquidity management. The problem was compounded by low demand for domestic debt instruments, as primary investors shifted their preference in favour of real estate and lending to private sector. In addition, the relative improvement of the harvests compared with the previous year, stimulated more demand for cash to finance crop-marketing, as reflected by the increase in liquidity in terms of currency in circulation outside banks.

The Bank of Tanzania however continued to exercise vigilance in its monetary policy actions so as to keep reserve money on track. Nonetheless, efforts to reduce liquidity to the targeted level were faced by upward pressure on interest rates for domestic debt instruments, and an appreciation of the shilling against the US dollar.

Besides the regular instruments used by the Bank of Tanzania to manage liquidity (i.e. Government securities, repurchase agreements, foreign exchange operations), the Bank intervened by selling more foreign exchange when appropriate. On the other hand, the government also continued to practice fiscal restraint, coupled with increased revenue collections, which exceeded targets in most of the months in the period under review. The above monetary and fiscal policy measures succeeded to contain within targets the quantitative benchmarks and performance criteria for the period through December 2004 **(Table 1).**

Table 1. Tanzania: Revised PRGF Targets for 2004/05

(Billions of TZS)

End of Period	Dec-04 Benchmarks	Actual	Mar-05 Performance Criteria	June-05 Benchmarks
NDF (ceiling)	-36.0	-256.1	48.0	157.0
NDA (ceiling)	-800.0	-1,066.0	-769.0	-776.0
M0 (ceiling)	1,000.0	967.8	984.0	1,028.0
NIR (Mill. of USD) (floor)	1,586.0	1,786.9	1,545.0	1,589.0

Note: NDF- Net Domestic Financing, NDA- Net Domestic Assets,
MO- Reserve Money, NIR- Net International Reserves

3.2 Credit Policy

During the first half of 2004/05, the Bank of Tanzania implemented its credit policy in a manner consistent with the targeted increase in bank credit to private sector in order to support the economic growth objective. The Bank, in collaboration with the government continued to facilitate restructuring and privatisation of the remaining state owned banks, with the view to further enhance competition and efficiency in the banking sector.

The Bank is also spearheading measures directed towards removing the remaining structural and institutional impediments to bank lending to private sector. Notable in this endeavour was the launching of a Credit Reference Bureau in September 2004. The bureau is expected to provide reference on creditworthiness of potential borrowers to facilitate credit risk assessment by banks.

Also, efforts towards instituting a regulatory and supervisory framework for micro-finance institutions and measures to develop institutional arrangements for provision of long-term finance are being coordinated by the Bank. The regulatory and supervisory framework for micro-finance will be put in place soon.

During the period under review, net claims on government by the banking system were projected to achieve a net repayment of TZS 158 billion. However, by December 2004, the government over-performed with a net repayment of TZS 256 billion, thus providing more available resources for the private sector.

3.3 Interest Rate Policy

The Treasury bill market continued to be the anchor for market determined interest rates. However, the momentum towards narrowing the spread between commercial banks' lending and deposit rates, as well as maintaining positive real interest rates, slowed during the period under review. To this end, the Bank of Tanzania in collaboration with the government continued to implement measures to address structural impediments in the economy that contribute to excessive risks in providing banking services. Among the measures, are the ongoing efforts by the government to improve the business environment, which have been partly responsible for increased investments. In response, commercial banks are offering negotiated interest rates to their prime customers that are much lower than the posted interest rates.

3.4. Foreign Exchange Operations

Foreign exchange operations were guided by the need to achieve a stable market determined exchange rate. In this respect and consistent with the price stability objective, the Bank of Tanzania continued to exercise interventions aimed at smoothening transitory fluctuations in the exchange rate so that market forces continue to play a greater role in determining the exchange rate. In addition, two-way quote mechanism was introduced in the Inter-bank Foreign Exchange Market (IFEM).

Under this arrangement IFEM participants are required to quote two exchange rates: one at which they are willing to buy, and another at which they are willing to sell, with a minimum trading lot of US$ 100,000. The system is expected to increase transparency in trading and reduce speculation in the exchange rate movements.

Despite a substantial increase in the demand for foreign exchange for importation of goods and services during the period under review, stemming from the increase cost of oil and food imports, the Bank of Tanzania continued to maintain adequate official international reserves. At the end of December 2004, official international reserves stood at US$ 2,296.1 million, equivalent to 8.8 months of imports of goods and services.

4.0 REVIEW OF MACROECONOMIC DEVELOPMENTS DURING THE FIRST HALF OF 2004/05

4.1 Output Developments

After a continued rise in growth of Gross Domestic Product (GDP) in real terms to reach 6.2 percent in 2002, the growth rate declined to 5.6 percent in 2003, due to drought, which adversely affected agricultural output. However, on account of a relative improvement in weather conditions, agricultural production is estimated to have improved somewhat in 2004, although food imports continue to meet the domestic shortfall.

Preliminary statistics show strong growth in mining, construction, transportation, communications, trade, and tourism activities. Improved growth in manufacturing sector is also evident, following rationalization of industrial power tariffs, increased investments, including in the Export Processing Zones, and the implementation of strategic trade policies favourable to manufactured goods for export. Given the strong performance in the non-agricultural sectors and the recovery in agricultural production, the projected real GDP growth of 6.3 percent for 2004 is likely to be achievable.

4.2 Price Developments

Tanzania Adopts New Consumer Price Index

Since September 2004, the National Bureau of Statistics is releasing the annual rate of inflation derived from new consumer price indices (CPI) based on expenditure weights obtained from the 2000/01 household budget survey (HBS) from January 2003 onwards. The new CPI weights represent the most current consumption pattern of a typical household in Tanzania based on household information collected in 2000/01 (Table 2). Henceforth, the inflation rates derived from the new CPI are now being used for macroeconomic policy analysis for Tanzania. The National Bureau of Statistics is currently revising the old CPI data from January 2003 backwards in order to change the base year of the series to 2001.

Table 2. Tanzania: CPI Weights Between Survey Periods

(All Urban)

Commodity Group	CPI weights Household Budget Survey 1969 %	1976/77 %	1991/92 %	2000/01 %
Food	47.0	64.2	71.2	55.9
Drinks and Tobacco	7.7	2.5	4.4	6.9
Rents	8.6	4.9	3.9	1.4
Fuel, Power and Water	6.6	7.6	4.7	8.5
Clothing & Footwear	10.8	9.9	3.7	6.4
Furniture & Household Equipment	2.8	1.4	2.5	2.1
Household Operations & Maintenance	3.5	3.4	1.5	2.1
Personal Care & Health	5.0	1.3	2.2	2.1
Recreation & Entertainment	1.6	0.7	1.2	0.8
Transportation	6.4	4.1	1.2	9.7
Education	0.0	0.0	1.5	2.6
Miscellaneous Goods and Services	0.0	0.0	2.0	1.5
TOTAL	100	100	100	100

Source: Tanzania National Bureau of Statistics

Headline Inflation

On account of the Bank of Tanzania inflation control measures, and the slowing of food price inflation, owing to the government's efforts to facilitate importation and distribution of food to deficit areas in the country, the overall inflation rate was contained below 5 percent throughout the period under review.

Based on the new consumer price index, the annual headline inflation reached the highest level of 4.7 percent in April 2004, with annual food inflation peaking at a high of 8.4 percent. The annual headline inflation decelerated from its peak level in April to 4.2 percent in December 2004, with food inflation falling to 5.9 percent.

Non-Food Inflation

The continued increase in the prices of petroleum products in line with the sharp increase in world market prices for crude oil, exerted upward pressure on non-food prices, particularly the cost of transportation, prices of manufactured products and their substitutes. As a result, the non-food inflation rose from its lowest level of –0.5 percent in April 2004 to 1.6 percent in December 2004. The nominal depreciation in the exchange rate during the period under review also affected prices of imported consumer goods and services.

4.3 Monetary and Credit Developments

Money Supply

Despite the steady inflow of foreign financial support to the budget, export earnings from seasonal export proceeds, and peak tourism receipts, the Bank of Tanzania, through its monetary policy instruments was able to control the growth of base money and ultimately money supply within the targeted growth path for the fiscal year 2004/05.

During July - December 2004, the stock of broad money supply (M2) increased by TZS 194.6 billion to a stock of TZS. 2,050.9 billion, while extended broad money (M3) increased by TZS 245.2 billion and was TZS 2,848.1 billion at the end of December 2004 **(Table 3)**. Despite the increase in money supply, the average growth rate of M2 and M3 during the review period remained within the programme target for 2004/05.

The expansion of money supply during the period under review mainly emanated from large inflows of donor funds in support of the government's poverty reduction initiatives, high demand for cash to finance crop purchase in 2004, and improved exports earnings, as well as tourism receipts.

Credit Developments

Consistent with the increase in demand for bank financing of economic activities in the country, credit to the private sector increased by TZS 94.1 billion during the period under review.

As at end December 2004, outstanding private sector credit from the banking system was to TZS 1,060.1 billion. The annual rate of growth of credit to the private sector averaged 34.9 percent during July – December 2004, which was slightly higher than the annual target of 34 percent. The high growth of credit to the private sector was largely due to increased economic activities, gradual decline in lending rates, and corporate clients switching from borrowing abroad to domestic borrowing to avoid exchange rate risks.

Table 3. Tanzania: Developments in Selected Monetary Aggregates

(Billions of TZS)

	2003		2004		Change Jun	Change Dec	Annual Change (%)	
Item	Jun	Dec	Jun	Dec	2003	2004	Jun 04	Dec 04
Extended broad money supply	2,205.9	2,388.3	2,602.9	2,848.1	182.4	245.2	18.0	19.3
Broad money supply	1,558.8	1,721.1	1,856.3	2,050.9	162.3	194.6	19.1	19.2
Currency in circulation	473.7	553.0	590.4	664.1	79.3	73.7	24.6	20.1
Demand deposits	507.4	560.3	595.6	651.6	52.9	56.0	17.4	16.3
Time deposits	246.7	231.0	269.1	276.4	-15.8	7.3	9.1	19.7
Savings deposits	330.9	376.8	401.1	458.8	45.9	57.6	21.2	21.8
Foreign currency deposits	647.1	667.2	746.6	797.2	20.1	50.6	15.4	19.5
Net foreign assets	1,871.3	2,182.1	2,134.2	2,379.9	310.8	245.7	14.0	9.1
Bank of Tanzania	1,215.0	1,503.5	1,468.9	1,715.3	288.4	246.4	20.9	14.1
Deposit money banks	656.2	678.6	665.3	664.6	22.4	-0.7	1.4	-2.1
Net domestic assets	710.3	660.2	962.9	932.5	-50.0	-30.4	35.6	41.2
Domestic Credit	858.2	830.1	1,123.6	1,012.4	-28.1	-111.2	30.9	22.0
Claims on government	489.9	464.4	515.2	477.6	-25.5	-37.7	5.2	2.8
Government deposits	290.2	451.5	357.6	525.3	161.3	167.6	23.2	16.3
Claims on the private sector	658.5	817.1	966.0	1,060.1	158.6	94.1	46.7	29.7
Other Items Net	-147.9	-169.8	-160.7	-79.8	-21.9	80.9	8.6	-53.0
Medium term foreign liabilities	41.8	41.7	41.1	39.1	-0.1	-2.1	-1.6	-6.3
Valuation account	333.9	412.3	453.0	425.3	78.4	-27.8	35.7	3.1

Source: Bank of Tanzania.

4.4 Interest Rate Developments

Interest rates on domestic currency denominated deposits registered marginal increases during the review period. The average saving deposit rate moved to 2.6 percent at end December from 2.4 percent in July 2004, while time deposits rate remained stable 4.4 percent.

Commercial banks lending rates on the other hand exhibited a declining trend over the review period. The rates for short-term loans of up to 1-year declined from 15.5 percent to 13.2 percent; medium-term (3-5 years) lending rates fell from 12.7 to 10.8 percent; whereas long-term loans (above 5years) rates dropped from 13.5 to 8.6 percent. Consequently, the overall weighted average lending rate also declined from 14.2 percent in July 2004 to 12.8 percent in December 2004. Similarly, the interest rate spread, measured by the difference between 12-month savings deposit and 1-year lending rates, declined from 9.8 percentage points in July 2004 to 7.8 percentage points in December 2004.

4.5 Government Budgetary Operations

During July - December 2004, overall budgetary performance was broadly in line with budget estimates. Revenue collections during the period exceeded projections by about 3 percent or TZS 19.2 billion mainly on account of higher collections of import duties and income taxes. The improved revenue collections come partly as a result of ongoing reforms of the tax administration system and improvement in the provision of customer services, which have increased tax payers compliance. The Tanzania inter-bank Settlement Scheme (TISS) has also improved the timeliness of tax payments.

On the other hand, there has been significant improvement in expenditure management, both in the priority sectors and in other charges of all government departments. During the review period, total expenditure amounted to TZS 1, 717.7 billion, which was above the estimated budget of TZS 1,344.7 billion. Out of the total, recurrent expenditures accounted for TZS 1,023.8 billion against the target of TZS 911.8 billion, while development expenditure was TZS 693.9 billion instead of the budget of TZS 432.9 billion. The higher than budgeted expenditure was partly attributed to frontloading of the donor pledged funds into development projects. However, for the whole fiscal year, total expenditure is likely to be at the budgeted level.

Despite the higher than anticipated expenditure for the period under review, good revenue performance and high inflows of external grants enabled the government to build up its deposits in the banking system to the tune of TZS 453.3 billion and to reduce its domestic debt obligations by TZS 178.7 billion.

4.6 Debt Developments

The country continued to receive external debt relief under the enhanced HIPC Initiative. During the period under review, Paris Club creditors continued to provide debt relief through debt cancellation in net present value (NPV) terms, while multilateral institutions provided additional debt relief, including the International Monetary Fund (IMF), International Development Association (IDA), and the African Development Bank (ADB).

As at end of November 2004, without reflecting the debt relief, Tanzania's total external debt was US$ 8,035.7 million, while domestic debt stock amounted to US$ 968.9 million. Between July and November 2004, external debt stock increased by US$ 505.2 million, from US$ 7,886.2 million in July 2004, whereas domestic debt stock slightly by US$ 6.35 million, from US$ 906.9 million at the end of July 2004. The rise in the overall debt stock during the period is associated with disbursements of new and existing loans, and accumulation of interest arrears for non- Paris Club debt.

External Debt Position

Up to the end of November 2004, in net present value terms, total debt relief from multilateral creditors amounted to US$ 322.5 million, while debt relief from bilateral creditors was US$ 931.2 million. Total debts cancelled by the Paris Club creditors under the Enhanced HIPC arrangement stood at US$ US$ 858.7 million. The government is continuing with efforts to obtain relief from creditors that have not yet offered relief under the HIPC and to negotiate with commercial creditors to extend relief at terms comparable to those offered under HIPC.

During the review period, India joined Bulgaria and Kuwait in confirming relief under the HIPC framework, in respect of government debt. Dialogue is also continuing with Abu Dhabi Fund, Libya and Iran. To consolidate achievements already recorded in external debt management area, the Bank is working with the Eastern and Southern Africa Macroeconomic and Financial Management Institute (MEFMI) to develop an inter-institutional capacity programme for this purpose.

Domestic debt

During the first half of 2004/05, domestic debt owed by the government went up from TZS 955.3 billion at end July 2004 to TZS 967.9 billion at the end of November. The increase is largely explained by special government bonds, which were issued to retire external debt under the debt swap arrangements.

4.7 External Sector Developments

During the year ending December 2004, the Tanzania's Balance of Payments surplus declined as a result of a substantial surge in imports, mainly food imports to offset the impact of drought–related food deficit and oil imports due to the sharp increase in oil prices. The deficit in the current account balance rose to US$ 538.4 million in the year to December 2004 from US$ 384.2 million recorded at the end of 2003 **(Table 4).**

Nevertheless, external sector performance improved during the first half of 2004/05, owing to a modest recovery of traditional exports, strong growth in non-traditional exports, improvement in tourism receipts and large official transfers. As a result, official international reserves increased substantially during the review period to reach US$ 2,296.1 million at end-December 2004, equivalent to cover 8.8 months of imports of goods and services.

Table 4: Trade, Current account and Overall Balance

(Millions of US$)

Item	2003 p	2004 p	% Change
Goods Account	**-804.2**	**-948.2**	**17.9**
Exports	1,129.2	1,325.2	17.4
Imports	-1,933.5	-2,273.4	17.6
Services Account	**-83.0**	**-135.2**	63.0
Receipts	686.6	859.2	25.1
Payments	-769.5	-994.4	29.2
Income Account	**43.9**	41.4	**-5.7**
Receipts	87.1	80.7	-7.4
Payments	-131.0	-122.1	-6.8
Current Transfers	**546.9**	**586.4**	**7.2**
Inflows	609.9	651.7	6.9
o/w General Government	543.3	582.0	7.1
Outflows	-63.0	-65.3	3.6
Current Account Balance	**-384.2**	**-538.4**	**40.1**
Overall balance	535.0	104.6	**-80.4**

Source: Bank of Tanzania

Note: p = Provisional data.

Exports

During the review period July-December 2004, Tanzania exported goods and services worth US$ 782 million up from US$ 632 million received in the corresponding period of 2003. The increase in export earnings was largely attributed to an increase in exports of manufactured goods, particularly sugar, textile apparels from export processing zones, plastic articles, iron and steel products and a substantial augmentation from gold exports on account of a rise in gold prices in the world market, as well as an increase in the volume of gold exported.

On the other hand, the value of traditional exports also recorded an increase during the period under review, mainly due to a rise in unit prices of most of the traditional commodities and significant increase in export volumes of cotton, tobacco and cashew, following good weather in producing areas, and usage of agricultural inputs such as fertilizers and pesticides. Export volume of cotton increased by 52 percent; tobacco by 48 percent, while cashew export volume increased by 22 percent.

Imports

During the year to December 2004, the import bill for Tanzania stood at US$ 2,273.4 million, compared to US$ 1933.4 million recorded in 2003: Due to expansion of economic activities, particularly in the mining, tourism and manufacturing sectors, imports of capital goods rose substantially to US$ 867.6 million, from US$ 741.5 million in the previous year. Also, importation of intermediate goods, mainly raw materials and agricultural inputs, increased from US$ 618.4 million in 2003 to US$ 658.4 million. Similarly, consumer goods imports increased to US$ 747 million during the year to December 2004, up from US$ 573.6 million, reflecting the needed importation of food to cater for food deficit areas during the year.

4.8 Foreign Exchange Operations

The volume traded in the Inter-bank Foreign Exchange Market (IFEM) declined to US$ 900.2 million in 2004 from US$ 976.4 million traded in 2003. However between July and December 2004, the volume traded in the IFEM increased to US$ 550 million compared to US$ 513 million traded during the corresponding period in 2003.

With a view to smoothen short-term fluctuations in exchange rate and to complement domestic liquidity management, the Bank of Tanzania occasionally intervened in the market during the period under review. The Bank sold about US$ 128 million between July and December 2004 and bought foreign exchange worth US$ 68.3 million, thus making a net sale of US$ 59.8 million.

The shilling appreciated in nominal terms against the US dollar to an average of TZS 1,005.9 per US dollar at the end of December 2004 from an average of TZS 1,099.8 per US dollar in July 2004, partly due to the increase in the supply of US dollars in the market and the weakening US dollar against major currencies in the world. Over the year under review, the exchange rate of the shilling to a US dollar appreciated to TZS 1,042.96 at end-December 2004, representing a nominal appreciation of about 2 percent from TZS 1,063.6 recorded at the end of December 2003.

5.0 MONETARY POLICY IMPLEMENTATION FOR THE SECOND HALF OF 2004/05

5.1 Liquidity management

During the remainder of 2004/05, the primary objective of monetary policy will continue to be directed towards maintaining appropriate level of liquidity in the economy to ensure low and stable inflation. Recognising the challenges of liquidity management against the backdrop of continued high donor funds inflows, the Bank of Tanzania will put in place measures to ensure that the evolving liquidity situation does not re-ignite inflation. The measures will include improving the efficacy of the existing monetary policy instruments, improving liquidity forecasting framework and introducing new policy instruments in response to challenges of monetary policy implementation.

5.2 Credit Policy

Credit to private sector is expected to grow stronger, as efforts to improve credit accessibility continue to be undertaken under the second-generation financial sector reforms. Restructuring and privatisation of the remaining state owned banks will also bring about more competition and efficiency in the banking system. In addition, the Bank of Tanzania will soon complete the work of putting in place an effective regulatory and supervisory framework for micro-finance institutions, which will facilitate a broader coverage of micro-finance services based on best practices. The Bank of Tanzania will continue to strengthen the Export Credit Guarantee Scheme (ECGS), while the pilot scheme for guaranteeing SMEs is expected to become operational during the second half of the financial year.

5.3 Interest Rate Policy

The Treasury bill market will continue to be the anchor for market determined interest rates. Thus, to enhance effectiveness of the anchor the bank will continue to observe its commitments towards promoting efficiency in the money market and the banking system in general. It is also expected that as competition in the financial system continues and risk to lending to the private sector is reduced as a result of ongoing reforms, the interest rates applied by commercial banks will move close to Treasury bill yields, and the spread between the deposit and lending rates will continue to decline.

5.4 Foreign Exchange Operations

In the regime of a market determined exchange rate, the Bank of Tanzania will intervene in the inter-bank foreign exchange market from time to time for the purpose of smoothening seasonal fluctuations in the supply and demand for foreign exchange. During these interventions, the Bank of Tanzania will remain mindful of its target of maintaining an adequate level of international reserves to cover a minimum of seven months of imports of goods and services during the fiscal year 2004/05.

5.5 Banking Supervision

The Bank of Tanzania will continue with its efforts to strengthen its supervisory and regulatory function over the banking sector. In this regard, the Bank will closely monitor both external and internal banking dynamics so as to keep abreast with technological advancements and the changing risk profile of banking institutions associated with new products and ways of doing business. The Bank of Tanzania will also continue to develop new prudential regulations on areas of risk based supervision, cross border supervision, consolidated supervision, anti money laundering and combating of terrorism.

5.6 Financial Sector Developments

During the period under review, the Bank of Tanzania played a coordinating role, as well as chairing of the Inter -Institutional committee for implementing broad based second-generation financial sector reforms based partly on the Financial Sector Assessment Programme (FSAP). The committee prepared an

Implementation Action Plan, which was shared with stakeholders through a workshop, which was conducted in December 2004. The steering committee is finalising the document for submission to the government before June 2005 for consideration and adoption.

Looking ahead, the role of the Bank of Tanzania is critical to the second generation reforms aimed at optimising financial sector contribution to investment and growth of the economy. In this respect, the Bank of Tanzania Act, 1995, and the Banking and Financial Institutions Act, 1992, are being reviewed to safeguard the independence of the Bank of Tanzania, and further strengthen the effectiveness of its operations, including the scope of the regulatory and supervisory function. The amendments to the two acts will be submitted to the parliament for enactment process.

6.0 CONCLUSION

Substantial progress has been attained in keeping the developments in monetary aggregates on track despite considerable pressure exerted on liquidity management. During the remainder of 2004/05, the Bank of Tanzania will maintain prudence in monetary policy so as to achieve monetary as well as broader macroeconomic objectives set for 2004/05 and in the medium term. In this connection the Bank will continue to take measures that will facilitate availability of credit to the private sector to support the targeted economic growth. This will include measures to promote diversity in products available to borrowers, especially the small and medium enterprises, and exporters, and putting in place an enabling environment for provision of long-term finance to productive sectors.

The Bank of Tanzania will remain committed to market determined interest rates in view of the success in reducing the spread between deposit and lending rates and in lowering the cost of borrowing. In this regard, the bank will collaborate with other stakeholders in addressing the high risk of doing banking business in the economy, so as to lower lending rates, improve deposit rates, and narrow the interest rate spread.

A regime of a market determined exchange rate has provided the best insurance of maintaining a realistic exchange rate. In view of the seasonal nature of foreign exchange transactions through the IFEM, the Bank will intervene from time to time as appropriate, only to smoothen wide fluctuations in the exchange rate.

APPENDIX 2: GRAPHICAL PRESENTATIONS

Chart 1. Tanzania: Annual Headline, Food, Non-food Inflation

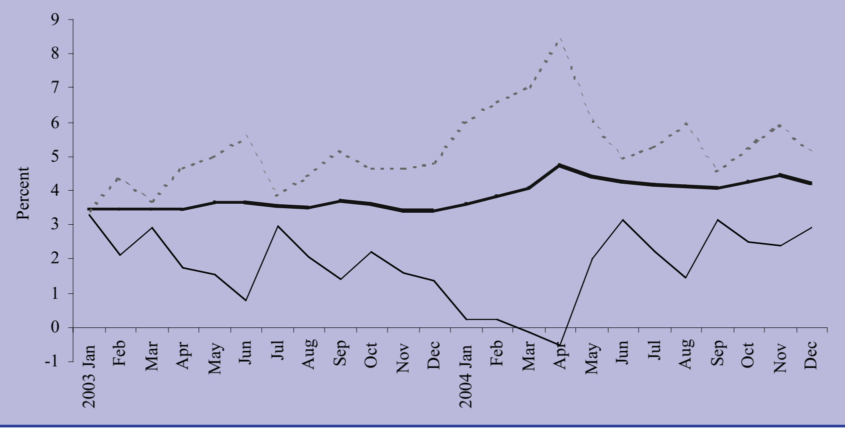


Chart 2. Tanzania: Annual Growth Rates of Monetary Aggregates

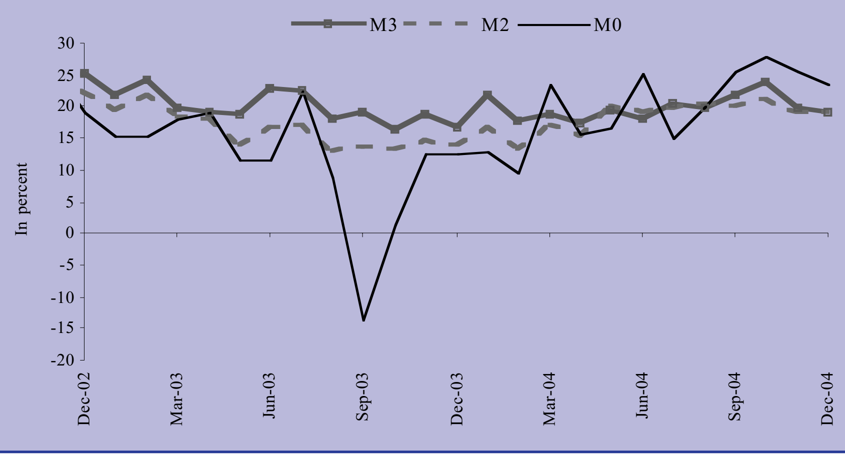


Chart 3. Tanzania: Sources of Money Supply (Billions of TZS)

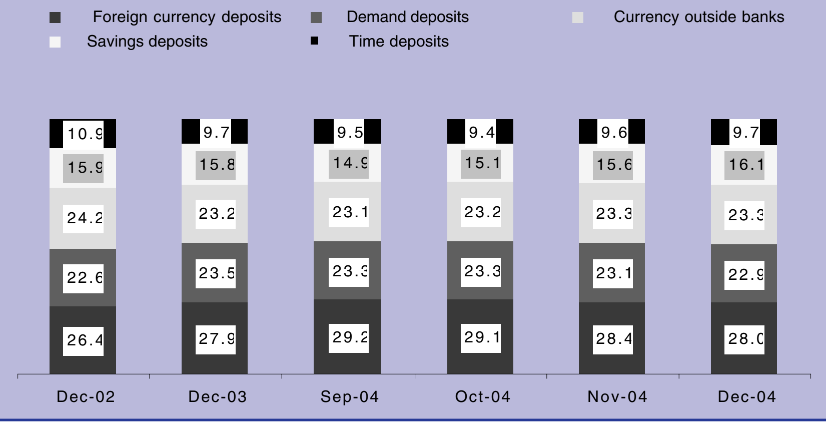
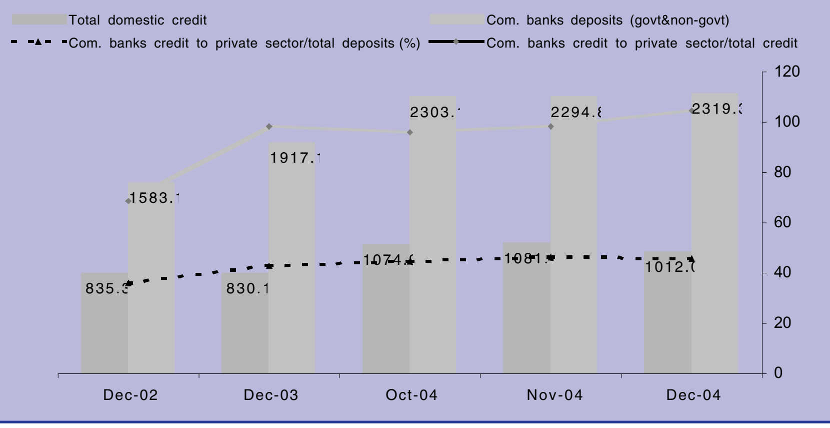


Chart 4. Tanzania: Structure of Deposits and Credit of the Banking System (Billions of TZS)



GLOSSARY

Average Rate of Inflation
This is calculated as the average of the inflation rates during the fiscal year, or the calendar year.

Currency in Circulation Outside Banks
Notes and coin accepted as legal tender in the domestic economy, excluding amounts held by the banking system.

Discount Rate
The rate of interest the Bank of Tanzania charges on loans it extends to commercial banks. At present, it is also the interest rate charged on government overdraft from the Bank of Tanzania. It is derived from the weighted average yield of treasury bills of all maturities plus five-percentage points.

Exchange Rate
This is the price at which one currency can be purchased with another currency, e.g. TZS per US$.

International Reserves, or Reserve Assets
They consist of those external assets that are readily available to and controlled by Central Banks for direct financing of balance of payments imbalances, and for indirectly regulating the magnitude of such imbalances through intervention in exchange markets. For the case of Tanzania, international reserves comprise

its holdings of monetary gold, SDRs, its reserve position in the International Monetary Fund, and foreign exchange resources, which can be made available to the Bank of Tanzania for meeting external financing needs.

M—Money Supply

The sum of currency in circulation outside the banks and deposits are defined in various concepts of Money Supply in the narrower and broader sense, i.e., Narrow Money (M1), Broad Money (M2), and Extended Broad Money (M3).

M0—Monetary Base, Base Money, or Reserve Money

The Bank of Tanzania's liabilities in the form of (1) Currency in Circulation Outside Bank of Tanzania, and (2) banks' Reserves (deposit money banks' domestic cash in vaults plus their required and free deposits with the Bank of Tanzania) is referred to as Base money, or the monetary base or reserve money.

M1—Narrow Money

It consists of currency in circulation outside banks and demand deposits.

M2—Broad Money

It is equivalent to Narrow Money (M1) plus time deposits plus savings deposits.

M3—Extended Broad Money

It consists of Broad Money (M2) plus foreign currency deposits.

Nominal Exchange Rate

It is the price at which actual transactions in foreign exchange markets occur.

Nominal Effective Exchange Rate (NEER)

This is the measure of the value of a currency against a weighted average of several foreign currencies, usually from the main trading partners. The NEER is often expressed as an index of the change in the exchange rate, relative to some base period.

Non-Food Inflation Rate

This is a measure of price movements caused by factors other than food prices. It is an important measure, which monitors the effectiveness of Monetary Policy on Inflation since price movements in these items are caused largely by Monetary Policy factors.

Real Effective Exchange Rate

This is the nominal exchange rate index divided by measures of relative price change or other measures of relative competitiveness. Under this approach, Consumer Price Indices (CPI) of our main trading partners relative to Tanzania's CPI are used to construct relative prices. The REER is commonly used as a general analytical tool for measuring relative over-valuation or under-valuation of a currency.

Reserve Money Program

It is an Operational Framework used by the Bank of Tanzania to achieve Money Supply Growth Targets, through monitoring Reserve Money, which is the Operational Variable.

Reserve Requirement

These are balances which banks are required to hold as a specified percentage of their liabilities (minimum reserve ratio) arising from demand deposits, savings deposits, time deposits, and foreign currency deposits, as well as from short-and medium-term borrowing, as balances on current accounts with the Bank of Tanzania.

Seasonally Adjusted Indicators

To enhance the vigilance of monetary policy, it is necessary to carry out seasonal adjustment, so that variations on a time series caused by seasonal factors are eliminated. Seasonal movements or seasonal variations, refer to identical, or almost identical, patterns, which a time series appears to follow during corresponding months (quarters) of successive years. Such movements are due to recurring events, which take place annually, as for example, the harvest season. Seasonally adjusted indicators show the impact of non-seasonal influences on a time series, thus showing more closely the impact of Monetary Policy.

Weighted Annualised Yields of Treasury Bills of all Maturities

This is the average yield of Treasury Bills, which is weighted by the volume, sold of 91-, 182-, and 364 - day Treasury Bills, expressed in percent per annum.