Assessment of Monetary Policy Transmission Mechanism in Tanzania

D. Kimolo, M. Sanga and A. Bashagi

Financial sector in Tanzania has recorded enormous developments especially since the 2000s that led to financial innovations particularly in payments systems and financial markets. This achievement is expected to ultimately impact the transmission mechanism of the monetary policy, either by changing the overall impact of the policy on key macro-economic variables or by altering the channels through which it operates.

This study assesses the effectiveness of various channels of monetary policy transmission in Tanzania. It employs structural Vector Autoregression (VAR) to evaluate the monetary policy transmission mechanism using quarterly time series data from 2002 to 2018.

The findings indicated that monetary policy actions pass through via credit supply to private sector were found to be significant which is important in fostering the growth of the economy.

However, policy transmission through other channels was found to be generally weak. To enhance the effectiveness of the transmission mechanisms, the study recommends continued financial sector reforms geared towards eliminating the remaining...
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(structed impediments that hinder financial sector development, including enhanced adoption of digital technology. The ongoing transition to interest rate based monetary policy framework is recommended since may enhance the effectiveness of monetary policy transmission as it is more forward-looking framework.)

The Impact of Financial Inclusion on Economic Growth in Sub-Saharan Africa

N. Balele

This study examines the impact of financial inclusion on economic growth in Sub-Saharan Africa. The financial inclusion index, considered as the overall index is developed from three main dimensions, that is, financial access, financial penetration, and financial usage.

The study uses random effect method with a sample of twenty-five Sub-Saharan African countries, each observed over six years from 2009 to 2014.

The estimation results showed that financial inclusion has positive impact on economic growth. This finding implies that, by leveraging financial technology, Sub-Saharan African countries can enhance economic growth, particularly by broadening financial access and usage among economic agents.

It is recommended that Sub-Saharan African countries have a role to minimize the prevailing hurdles on both access and usage of financial services. These hurdles include higher financial transaction costs especially interest rates and other costs emanating from charges and fees on usage and access of financial services.

Equally important is enhancing use of national identities, national switches and Credit Reference Bureau to promote financial inclusion and growth.

Currency convertibility within the EAC Region: The case of Tanzania

A. Liyau, C. Nkya, E. Mgangaluma, N. Kessy and P. Mboya

Currency convertibility is the acceptability of a country’s currency for exchange with another currency without limitations. Economies with convertible currencies tend to have stronger trade linkage as cross-border transaction costs between them are low and markets are easily accessible. Cognizant of these benefits, several countries in the region and across the globe are pursuing currency convertibility arrangements.

For East African Community (EAC) Partner States, the MOU to accept each other’s currencies became operational in May 2014 as an interim measure to achieve single currency by 2024. Since then, several measures have been undertaken by the Partner States including establishment of the East African Payment System (EAPS) to facilitate currency clearance and settlement as well as opening
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reciprocal accounts for collection and repatriation of EAC Partner States’ currencies. This study examined the extent of currency convertibility in the EAC region, largely focusing on the extent and the role of financial institutions and other players in facilitating currency convertibility.

The results indicate that currency convertibility in the region has increased notably following enforcement of the MOU. For instance, total value of transactions have increased from an equivalent of USD 93.8 million in 2015 to USD 241.8 million in 2017, which is an increase of 157.8 percent. Banks were found to be the main players accounting for 94.5 percent of the total value of transactions. It was evidenced that, individual clients and retail traders were the major purchasers and suppliers of EAC currencies, accounting for 59.7 percent and 59.0 percent of respondents, respectively. The sources of EAC currencies include trade, proceeds from investment and remittances.

(Full paper available in the BOT’s Working Paper Series: www.bot.go.tz)

Determinants of Banks Lending Interest Rates in Tanzania: An Investigation Using Banks Balance Sheet Data

W. E. Mbowe, A. Mrema and Sia Shayo

Tanzania embarked on a series of financial reforms in the 1990s with a view to support the development of a market-based financial sector. Following the reforms, the sector has continued to record notable developments. For instance, the ratio of banks credit to the private sector to GDP increased from 4.1 percent in 2001 to 16.0 percent in 2016. In spite of this performance, banks interest rate spread has persistently remained high even defying rising competition in the sector as a result of increasing number of banks from 3 in 1991 to 53 in 2018. In addition, the ratio of private sector credit to GDP is still low compared to peer countries in the EAC and SADC regions. Against this background, this study seeks to examine the determinants of banks’ lending interest rates in Tanzania and their relative importance. The approach used include the analysis of interest rate decomposition as well as econometric technique using banks’ balance sheet data.

Results on interest rates decomposition reveal that, the main drivers of lending rates are operating costs, non-performing loans, and costs of funds. The three indicators accounted for 70.4 percent of small banks’ average lending rates; while for medium and large banks, they constituted about 69.5 percent and 67.4 percent of the lending rates, respectively. Statutory minimum requirement (SMR) ratio appears to play an important role in all banks’ lending rates, but its share has been declining overtime consistent with the accommodative monetary policy measures pursued since 2014.

Diverse factors including bank specific, regulatory, and macroeconomic variables explain banks’ lending rates dynamics in the country

Similarly, econometric estimations confirm the role of operating costs, non-performing loans, and costs of funds in explaining banks’ lending rates dynamics. Operating costs, cost of funds, and inflation were found to have a statistically significant positive effect on banks’ lending rates, while bank size and level of liquidity have a negative influence. SMR ratio was statistically significant but bears a negative sign except for locally owned banks. In relative importance, the main determinants of banks’ lending

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rates could be ranked as follows: inflation with an average positive impact of 0.432 on lending rates for a unit change in inflation, trailed by operating costs (0.261), and cost of funds (0.255). Bank size had the largest negative effect of 0.288 for every unit increase in the variable. These factors were also found to be significant but with some variation across bank categories.

The implications of these findings are that effort should be directed at improving operational efficiency aiming at reducing banks operating costs. The key areas of attention are with respect to employees’ salaries and benefits, as well as rental and depreciation expenses. In this, banks may increasingly adopt ICT as well as agent banking and service provision to cut on costs. Prudent consolidation of small banks could as well help cut on operating costs, improving efficiency, and enhancing liquidity levels.

Role of Financial Innovation in enhancing MSMES access to credit: An empirical investigation on Tanzania

W.E. Mbowe, F. Shirima and D. Kimolo

Access to reliable and affordable financial services to the majority of the Tanzanians matters in fostering economic development through industrialization. In recognizing the role of financial services, the Government undertook several initiatives including financial reforms aiming at putting in place a vibrant financial sector. Following these initiatives, the financial sector recorded significant achievements, including increased number of private financial institutions, and innovation in financial services provision, particularly credit to private sector.

The understanding on the level to which these innovations in the financial sector have contributed to the improvement in credit access by the Micro, Small and Medium Enterprises (MSMEs) is however not well known.

The study evaluates the extent to which financial innovations contribute to enhancing MSMEs’ access to credit in Tanzania using interviews and probit estimation approach. More specifically, the study assessed the level of MSMEs access to credit through innovative platforms in comparison to traditional banking system, and established factors which influence MSMEs to take loans through innovative channels, and the constraints. It also investigated the statistical importance of innovative platforms and other constraints in enhancing the probability of MSMEs to borrow. The study found that access to credit by MSMEs through innovative channels, is still low. For instance, only 28.8 percent

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of 318 respondents acknowledged to have received loans through innovative platforms, i.e., MFIs, SACCOS, saving groups, leasing, subcontracting, mobile phone system. Furthermore, different factors were found to explain why MSMES borrow money through innovative channels. These include ease of access, convenience, short loan process, and degree of control of the loan process by the borrower. Probit results indicated that borrower’s perception about lending process and risks of losing collateral, loan size, and loan repayment period are statistically significant. It was found that as loan size and repayment period increase and borrowers perceive the lending process to be easy the probability of MSMES taking loan also increases. Furthermore, the probability to borrow tends to be lower if borrowers perceive the borrowing to be risky. Meanwhile, loan process time, loan size, loan access (distance) have a higher probability of increasing loan access by MSMES.

The study recommends the need to intensify measures towards enhancing MSMES access to credit, partly taking advantage of available innovative platform channels. These include intensifying efforts in reducing credit risk, which is important for lowering lending rates. Similarly, it is important to strengthen the regulatory and supervisory role in order to reduce unfair terms of loans, ensure collateral protection, reduce transaction costs, improve service delivery, and ensure the sustainability of financing.

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Exchange rate volatility and its implication on macroeconomic variables in East African Countries

N. Yabu and D. Kimolo

During the early 1990s, all EAC countries adopted a range of economic reforms, partly geared towards more outward-looking trade and market-determined exchange rate policies. Since the adoption of market-determined exchange rate regimes, exchange rates of the EAC member states have been subjected to notable fluctuations. For instance, during the second quarter of 2015, all EAC currencies recorded a substantial depreciation against other major currencies. This persistent behavior of exchange rate has raised concern about its effect on other macroeconomic variables in the economy at large.

This study examines the extent of exchange rate volatility and its impact on key macroeconomic variables such as exports, Foreign Direct Investment (FDI) inflows, interest rate and inflation in Tanzania, Kenya and Uganda. The Generalized Autoregressive Conditional Heteroskedasticity (GARCH) model was used to compute the extent of exchange rate volatility while the Panel Autoregressive Distributed Lag (ARDL) technique or pooled mean group (PMG) estimator was used to estimate the effects of exchange rate volatility on selected macroeconomic variables.

Exchange rate volatility appears to be detrimental to export performance and leads to a reduction in lending rates in the short run. However, in the long run, exchange rate volatility was found to have a positive impact on export performance and lending rates, reflecting persistent depreciation effect of the currency.

The results indicate that volatility in the exchange rate is a real issue in all the sampled countries and was found to significantly affect exports and FDI dynamics for the period under consideration. It was found that exchange rate volatility appears to be detrimental to export performance and leads to a reduction in lending rates in the short run.

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Exchange rate volatility and its implication on macroeconomic variables in East African Countries

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However, in the long run, exchange rate volatility was found to have a positive impact on export performance and lending rates, reflecting persistent depreciation effect of the currency. Further, the response of FDI to exchange rate volatility was found to be negative in the long run, while in the short run, the response was statistically insignificant.

The study recommends that policymakers need to enhance mitigation measures which could smooth out excessive exchange rate volatility to minimize its likely negative effects on the economy.

(Full paper can be accessed from Journal of Applied Economics and Finance Vol. 7, No. 3; May 2020)
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