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BANK OF TANZANIA

FINANCIAL STABILITY REPORT

March 2011

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LIST OF ACRONYMS

BOT	-	Bank of Tanzania
EAC	-	East African Community
EU	-	European Union
EMEs	-	Emerging Market Economies
Forex	-	Foreign Exchange
GDP	-	Gross Domestic Product
GFC	-	Global Financial Crisis
IFEM	-	Interbank Foreign Exchange Market
IMF	-	International Monetary Fund
NPL	-	Non-Performing Loans
SDC	-	Sovereign Debt Crisis
TZS	-	Tanzanian Shilling
US	-	United States
USD	-	United States Dollar
WEO	-	World Economic Outlook

GOVERNOR's FOREWORD

This second edition of the Financial Stability Report reflects the Bank's continuing commitment to communicate the assessment of potential risks to the financial sector stability. The Report covers financial sector developments during the period between June and December 2010 and the outlook. Essentially, it highlights the assessment of risks in the financial system done by the Bank of Tanzania and the capacity of the system to sustain its financial intermediation role in the economy. It also reports the surveillance and supervisory measures undertaken by the Bank to ensure continued safety and soundness of the banking system in particular and promote the stability of financial and payment systems in general.

According to the assessment of the Bank of Tanzania during the period under review, the Tanzanian financial system remained stable and resilient to shocks and it is expected to remain so for the coming six months until the next assessment. Conditions in the domestic financial markets and the payment systems remained sound and efficient enough to support smooth financial transactions in the economy and thus facilitating the domestic economic activities. To verify the soundness of the banking system – representing 75.0 percent of total assets of the financial sector, the Bank of Tanzania conducts stress tests on banks' aggregated balance sheet to illustrate the sensitivity of the banking industry's net worth to given risks and adverse shocks. Through stress testing and daily surveillance of the banking system transactions, the Bank is able to detect any early warning signals to financial instability and take the appropriate pre-emptive interventions. In recognition of the growing cross-border operations of Tanzanian licensed banks, the Bank of Tanzania have signed MOUs with banking sector regulators of respective host countries to facilitate joint supervision of the relevant financial institutions in order to mitigate cross-border contagion.

Since the pursuit of financial stability is a continuing endeavor on the dynamic and multiple developments in the financial sector, the Bank of Tanzania is committed to continuously widen and strengthen its surveillance of the financial sector activity, and promote measures to mitigate the incipient risks to financial stability. In this regard, work is ongoing to assess the soundness and sustainability of the pension funds – which together account for about 20 percent of the total financial assets in the financial system. Hence, the next report will include risk assessment of this subsector, any contagion to the banking system and measures to contain such risks.

Nevertheless, the Bank recognizes that financial stability can only be achieved through coordinated efforts of all financial sector regulators, self-regulatory agencies and financial market participants. In that regard, the Bank is finalizing a mechanism for the needed coordination in the financial sector to promote measures for crisis preparedness, mitigation and crisis management and resolution when mitigation fails.

We hope this Report would provide useful insights and information to financial stability stakeholders.

Prof. Benno Ndulu
Governor
31st March 2011.

OVERVIEW

This issue of the Financial Stability Report focuses mainly on the six-month period ending December 2010. Since the release of the September 2010 Financial Stability Report, the global financial system has remained vulnerable and hence, significant policy challenges still need to be addressed. Pockets of vulnerability and risk remain, mainly in the form of sovereign risk in the euro area, banking-sector vulnerabilities in the US and euro area, continuing deleveraging in advanced economies and large amounts of capital flows to emerging and developing market economies. These developments present challenges to policy-makers and add to the risk of sudden reversals of inflows.

The global economic recovery remains uneven with subdued economic growth and high unemployment in advanced economies, and buoyant economic activity and emerging inflation pressures in many EMEs. Distressed labour markets and low levels of credit extension in the banking sector continue to impact negatively on the pace of economic recovery in the US. Similarly, in the euro area, the economic recovery is expected to be challenged by uncertainty surrounding sovereign debt and planned fiscal tightening.

Emerging and developing economies remained important drivers of global economic growth in the second half of 2010 with countries in developing Asia recording the most rapid growth among all EMEs. Projections for 2011 and 2012 show that economic growth in EMEs is slightly lower than in 2010, given the lingering downside risks in the form of rising inflationary and overheating pressures, a sudden reversal of capital inflows and sharp fluctuations in commodity prices. Many developing economies, particularly in sub-Saharan Africa, are also growing strongly, although growth prospects will still depend on a sustainable recovery in the global economy. The recent political instability in the Middle East and North Africa region may dampen the flow of funds into the region. Meanwhile, the resulting rise in oil prices, coupled with rising food prices, poses significant challenges to the economic outlook not only in the region but to the rest of the world.

Banking-sector vulnerabilities remained a concern in advanced economies. In some cases these vulnerabilities were addressed by an increase in regulatory capital ratios. Similarly, Euro area banking systems remain vulnerable to deterioration in the credit quality of their sovereign debt holdings. In a nutshell, the recent global and financial market developments are presenting challenges for monetary policy makers around the world, who have to ensure that they maintain credibility and protect macroeconomic stability by managing inflation risks, while at the same time avoiding undue damage to growth prospects by possibly acting too hastily to remove accommodative monetary and fiscal policies.

In Tanzania, the level of public confidence in the financial services sector remained strong as reflected by smooth operations in the financial system with increasing private sector deposits in banks. On the other hand, during the six months to December 2010, banks scaled down the accumulation of excess reserves that was triggered by the global financial crisis in 2008. As a result, lending to private sector was stimulated in line with the increasing confidence in the performance of the economy.

The banking sector remained stable with all the monitored soundness indicators being above the minimum regulatory requirements. In a nutshell, the banking system was adequately capitalized and sufficiently liquid. The financial intermediation remained smooth and strong - being supported by an ample liquidity environment and orderly conditions in the domestic financial markets and in the payment and settlement systems.

The contagion risks arising from the global financial developments had negligible impact on the financial sector in Tanzania, due to the low and mostly indirect exposures of financial institutions to counterparties in the global financial markets. As such, any potential credit losses in the event of widespread sovereign defaults would also be limited. The credit risk to the financial institutions emanating from their overseas placements remained limited due to the existing prudential regulation system which requires banks to spread their placements according to the credit rating of the foreign banks. In addition, banks are required to monitor their foreign exchange risks, including placements abroad and report to the Bank of Tanzania on daily basis. Parent banking groups have limited access to their Tanzanian subsidiaries' foreign exchange reserves because of the independent nature of their licensing. Foreign banks are registered and licensed as independent legal entities separate from their foreign parent banking groups. This regulatory arrangement limits the exposure of foreign owned banks in Tanzania from risks arising from the performance of their parent banking groups.

The resilience of the Tanzanian financial system continued to be sustained during the reporting period. The risk-bearing capacity of the financial system to weather the extreme macroeconomic and financial conditions was re-affirmed by the monthly stress tests carried out on the banking system – which is the main segment of the financial sector, accounting for 75 percent of financial sector assets. The results of the scenario-based stress tests, covering both market and credit risk exposures conducted by the Bank for the period ending 31st December 2010 showed that the Tanzanian banking system was resilient to adverse changes in interest rates, the exchange rates, as well as in the level of non-performing loans and default of large borrowers in the banking system.

The outlook of domestic financial stability for the coming six months remains positive and supported by underlying strengths of the Tanzanian financial system as proven by the stress tests conducted by the Bank on the banking sector during the period ending December 2010. The banking system has accumulated strong financial buffers against the risk weighted assets, as reflected by both the capital adequacy ratios and liquidity levels being above the regulatory minimum requirements. The buffer provides the strength to the financial system to withstand financial risks and domestic challenges, even under extreme credit and market conditions simulated under stress testing.

Despite the positive outlook in economic and financial environment, the dynamic developments in domestic financial environment may always pose potential challenges to financial stability. Inevitably, shifts in global liquidity in search for higher yielding assets in EMEs and developing countries including Tanzania may continue to pose challenges of currency appreciation, and inflationary pressures. If not well addressed, these challenges may result in financial instability.

Mindful of the potential risks to financial stability, the Bank remains vigilant in its surveillance of the financial system for any early warnings and is committed to promote pre-emptive measures accordingly. Work on the assessment of the health and sustainability of the pension sector is also ongoing and will be reported in the next Financial Stability Report. On its part, the Bank of Tanzania continues to monitor the soundness of the financial institutions under its prudential supervision regime and requiring the relevant institutions to take prompt corrective measures as needed to safeguard financial stability.

1.0 Macroeconomic and Financial Environment

1.1 Developments in the Global Economy and Financial System

1.1.1 Global Economic Growth

During the six months since the last Financial Stability Report in September 2010, the global economic recovery continues to be uneven and uncertain with downside risks remaining significant **(Table 1.1).** With fiscal stimulus slowly being phased out in advanced economies, both private consumption and investment remain weak; most advanced economies are recovering slower than earlier projected. The environment of near-zero interest rates and deflationary pressures in advanced economies, coupled with the sovereign debt crisis in the Euro zone have further dampened domestic economic activity. The prolonged low interest rate scenario reduces the opportunity cost of capital and encourages a yield – seeking environment including investments in assets in emerging and developing markets.

In contrast to advanced economies, many emerging and developing economies record strong economic growth driven by both consumption and investment. Most of the emerging market economies have already recovered fully to their pre-crisis growth rates. The strong growth in the emerging and most developing countries is being mainly driven, among other factors, by supportive macroeconomic policies and recovery in trading partner countries, and the induced capital inflows from advanced economies in search of higher returns to investments. The increased demand for goods and services to sustain the strong growth rates has also resulted in higher commodity prices – which act as stimulus and incentive for more commodity production.

1.1.2 Global Financial Developments

As higher growth rates are sustained in EMEs and developing economies, monetary policy accommodation is being gradually withdrawn and policy interest rates are being subsequently raised. This phenomenon creates an incentive for large capital inflows from advanced economies into emerging and developing economies. Inevitably huge capital flows are accompanied by challenges in domestic financial markets of the recipient countries. Depending on the country's absorption capacity, huge capital inflows might result into currency appreciation and loss of export competitiveness. Also, the receiving country becomes vulnerable to sudden reversals which may destabilize the domestic financial markets and the broad economy.

The accommodative monetary policy stance adopted by most advance economies to weather the storm of the crisis appears to have weakened the major currencies. In the US in particular, easy monetary policy led to a weaker USD and according to various reports, several economies in advanced and emerging markets have reportedly stepped-up intervention in their foreign exchange markets, in a bid to arrest the appreciation of their respective currencies – especially those countries enjoying large current account surpluses with the US. On the other hand, many economies are also experiencing weak fiscal positions, mainly due to fiscal expansions implemented to contain the adverse impact of the Global Financial Crisis (GFC). Moreover, the continued turbulence in sovereign debt markets, particularly in the Euro Zone has strongly underscored the need for countries to have credible medium-term fiscal consolidation plans so as to ensure financial stability. Indeed, the Euro debt crisis has also demonstrated the challenges imposed by a unified currency in crisis management due to strong contagion effect stemming from implementation of a unified monetary policy.

On global funding markets, significant improvements have been recorded. In fact since the on-set of the GFC, financial institutions globally have worked to reduce the large losses, strengthened capital and liquidity buffers, and have lowered leverage. Nevertheless, weaker banks continue to depend on support from central banks and governments. However, going forward, these banks are likely to face a major refinancing challenges in line with the redemption profile of maturing sovereign debts in the coming few years. Funding problems could also arise from potential competition with sovereigns in bond markets or for specific institutions, prompted by renewed stress in sovereign debt markets. These problems could quickly become more widespread given the complex linkages of institutions and markets within and across borders. This looming situation is one of the major sources of uncertainty in the global economic and financial recovery.

Table 1.1: World GDP Growth Rates

	Year to Year					
	2009	**2010**		**2011**		**2012**
	Actual	**Proj**	**Updt Jan 2011**	**Proj**	**Updt Jan 2011**	**Proj**
World output	-0.6	4.6	5.0	4.3	4.4	4.5
Advanced Economies	-3.4	2.6	3.0	2.4	2.5	2.5
USA	-2.6	3.3	2.8	2.9	3.0	2.7
Euro area	-4.1	1.0	1.8	1.3	1.5	1.7
Japan	-6.3	2.4	4.3	1.8	1.6	1.8
United Kingdom	-4.9	1.3	1.7	2.1	2.0	2.3
Emerging and Developing Economies	2.6	6.3	7.1	6.4	6.5	6.5
Sub-Saharan Africa	2.8	4.7	5.0	5.9	5.5	5.8
Great lakes region	4.7	6.0	6.0			
Tanzania	6.0	6.5	6.9	6.9	7.1	7.2
South Africa	-1.7		2.8		3.4	3.8
Developing Asia	7.0	8.7	9.3		8.4	8.4
China	9.2	10.2	10.3	8.9	9.6	9.5
India	5.7	8.8	9.7	8.6	8.4	8.0
Western Hemisphere						
Brazil	-0.2	5.5	5.5	5.1	4.5	4.1
Mexico	-6.5	4.2	5.0	3.0	4.2	4.8

Source: WEO, IMF

1.1.3 Outlook on Global Financial Environment

The level of government debt in some advanced economies will require significant and protracted fiscal consolidation, which will largely involve, among others, limiting government expenditure – which implies that inflationary pressures may become relatively contained. If that happens, monetary policy in advanced economies can afford to remain expansionary in the near future, and maintaining lower interest rates than those in emerging economies. In contrast, the emerging economies and developing countries, which have become preferred destinations for capital inflows, might need to adopt a tighter monetary policy stance in the near future to address inflationary pressures associated with high liquidity resulting from capital inflows.

In terms of growth prospects, it is expected that the dual speed recovery in the world economy will continue, while taking full cognizant of the fact that policy decisions in large countries have repercussions on the rest of the world. Consequently, any changes to the current stance of affairs in the advanced economies in the next six months will have an impact on the global economic outlook accordingly. Meanwhile, managing the challenges associated with cross-border capital flows and their implications to financial stability in emerging and developing market economies will remain a priority. Indeed, it seems, managing pressures on the exchange rate, trade balance and consumer prices is shaping-up as one of the major macroeconomic policy challenges to financial stability for 2011.

In a nutshell, the recent global and financial market developments are presenting challenges for monetary policy makers around the world, who have to ensure that they maintain credibility and protect macroeconomic stability by managing inflation risks, while at the same time avoiding undue damage to growth prospects by possibly acting too hastily to remove accommodative monetary and fiscal policies.

1.2 Lessons from the Global Financial Crisis

The turbulences experienced during the GFC have raised a number of questions about the structure and adequacy of the existing regulatory and supervisory regimes around the world for addressing some of the problems that surfaced. The analysis of the pre-crisis financial environment revealed, among others, critical gaps in the financial regulatory frameworks. As such, a lot have happened on the international financial stability agenda aimed at reducing the probability and severity of future crises. Various groupings of financial authorities and international standard setters, including the Group of Twenty Forum (G-20), the Basel Committee on Banking Supervision and the Financial Stability Board are actively engaged towards initiatives to create a stronger international regulatory framework to safeguard financial stability. Individual countries have also responded by strengthening their respective financial sector regulatory regimes to ensure a much safer financial systems. Furthermore, the roles and responsibilities of most central banks in regulating and supervising financial institutions have been extended to ensure promotion of financial stability. So far, the international regulatory reform agenda has three main building blocks: First, Basel III as endorsed by the G20 group of countries; second, new rules for regulating the systemically important financial institutions; and third; adequate regulation of the shadow banking sector **(Box I)**.

However, the recommended reforms need to be adapted to the respective national structures. On its part, the Bank of Tanzania continues to improve its own regulatory regime, while keeping in mind the EAC regional harmonization agenda on regulation and supervision of the financial sector as a whole. The regional agenda notwithstanding, the Bank remains committed to provide a regulatory environment that provides appropriate incentives or penalties to induce prudent behavior, encourages innovations and development of strong financial institutions in Tanzania.

BOX I: Global Financial Regulatory Reforms

I. Basel III Reform Package

The Basel III framework is the cornerstone of the G20 regulatory reform agenda and the result of an unprecedented process of coordination across 27 countries. It is noteworthy that the full potential of Basel III will only be achieved if all Committee-member countries and regions fully implement the minimum standards. However, some countries may choose to implement higher standards to address risks particular to their national contexts. This has always been an option under Basel I and II, and it will remain the case under Basel III.

Why is Basel III fundamentally different from Basel I and Basel II?

Basel III combines micro- and macro-prudential reforms to address both institution and system level risks. On the micro-prudential side, these reforms mean:

- *A significant increase in risk coverage, with a focus on areas that were most problematic during the crisis, that is trading book exposures, counterparty credit risk, and securitization activities;*

- *A fundamental tightening of the definition of capital, with a strong focus on common equity. Also, an introduction of requirements that all capital instruments must absorb losses at the point of non-viability, which was not the case in the crisis;*

- *The introduction of a leverage ratio to serve as a backstop to the risk-based framework. The leverage ratio is to serve as a back-stop to the risk-based measure. Indeed, calibration work showed that bank leverage was a highly significant determining factor between banks that ultimately failed or required government capital injections during the crisis and those that did not. The leverage ratio also has system-wide benefits by preventing the excessive build-up of debt across the banking system during boom times.*

- *The introduction of global liquidity standards to address short-term and long-term liquidity mismatches. The objective of establishing the liquidity framework is to require banks to withstand more severe shocks than they had been able to in the past, thus reducing the need for such massive public sector liquidity support in future episodes of stress. Under the framework, banks that take on excessive liquidity risk shall be penalized.*

- *Enhancements to supervisory review process and market discipline, particularly for trading and securitization activities.*

On the Macro-level

- *The introduction of macro-prudential elements into the capital framework. This includes: Standards that promote the build-up of capital buffers in good times that can be drawn down in periods of stress, as well as clear capital conservation requirements to prevent the inappropriate distribution of capital.*

II. Shadow Banking

It has been observed in various international financial stability forums that the implementation of the new capital standards for banks might increase the incentives of businesses to migrate to less regulated institutions in the "shadow banking system" from the well regulated financial institutions in the formal banking system. In that case, risks arising from the shadow banking system can be transmitted to the whole financial system. Investment banks, structured investment vehicles and mutual funds, are cases of shadow banks that lacked adequate regulatory oversight and which intensified the 2007/8 financial crisis in the United States. To address the potential systemic risks arising from the shadow banking system, the FSB in collaboration with other international standard setting bodies (i.e. IOSCO, ISA, IASO etc), are developing a framework for strengthening the regulation and oversight of shadow banking systems.

III. Systemically Important Financial Institutions and Resolution

The fallout from the crisis underscores the need to put in place additional measures to reduce the likelihood and severity of problems emerging at systemic financial institutions. Consequently, the global regulatory community is developing a framework to address the financial system's moral hazard risks created by Systemically Important Financial Institutions (SIFIs). The framework will cover measures to mitigate the probability and impact of SIFIs failure, improving the capacity to resolve SIFIs without tax payers bearing the costs and strengthening the financial infrastructures and markets in order to reduce contagion risks. In addition, the framework will incorporate mechanisms to level the playing field by reducing too-big-to-fail competitive advantages in funding markets. Ensuring effective supervisory oversight is the key component of the FSB policy on SIFIs. The policy requires country regulatory authorities to identify such institutions and develop appropriate regulatory measures taking into account their size, interconnectedness and lack of substitutability.

1.3 Domestic Macroeconomic Developments

1.3.1 Economic Growth

Given the interconnectedness of the financial and real sectors of the economy, the financial sector is potentially exposed to contagion from a wide range of shocks arising from non-financial sectors, rendering it necessary to assess developments in these sectors simultaneously and examine how they pertain to the stability of the financial system. Essentially, financial instability affects the real sector due to its links which have the potential to interfere with production, consumption and investment decisions and therefore affecting attainment of the government goals of economic growth and development. In this section, the stability of the financial system is assessed by analyzing indicators of real economic growth and the external sector, highlighting potential areas of concern relevant to the financial sector.

The economy recorded a real GDP growth of 7.0 percent for 2010, up from 6.0 percent registered in 2009. The analysis of sources of growth in 2010 indicated that trade, agriculture and fishing, transport and communication, as well as manufacturing activities were the main drivers. These activities are also the leading borrowing sectors. The outstanding credit to trade activities accounts for an average of 18.0 percent, manufacturing 14.0 percent, agriculture 10.0 percent and transport and communication 10.0 percent of total credit to private sector. In total, financing of these activities account for about 52.0 percent of total private sector credit. It is important to note that, while there is a boom in construction sector, the share of lending to this activity is less than 5.0 percent. This implies that alternative sources of finance are used to fund the booming construction activity—an area that calls for further research. The economic activity is projected to slow down slightly during 2011, mainly on account of the projected drought-related power shortages coupled with higher international oil prices and the geo-political tensions in North Africa and Middle East. On that background, the growth forecast for 2011 was put at 6.0 percent. However, rainfall has been above earlier projections and arrangements are underway for additional investment in other sources of electricity including thermal and solar to complement the hydro-power sources in the country. Furthermore, the pressure on domestic oil prices is poised to ease beginning the second half of 2011, following the envisaged fiscal measures to reduce the level of taxation on fuel. Consequently, with these measures in the pipeline, the forecast for GDP growth in 2011 is likely to be revised upwards.

1.3.2 Performance of the Tanzania External Sector

Even as uncertainty continued to hang over prospects for recovery of the global economy during the second half of 2010, the performance of Tanzania's external sector particularly the export frontier continued to recover from the slowdown registered in 2009, thanks to the continuous strengthening of the non-traditional export sector **(Table 1.2)**.

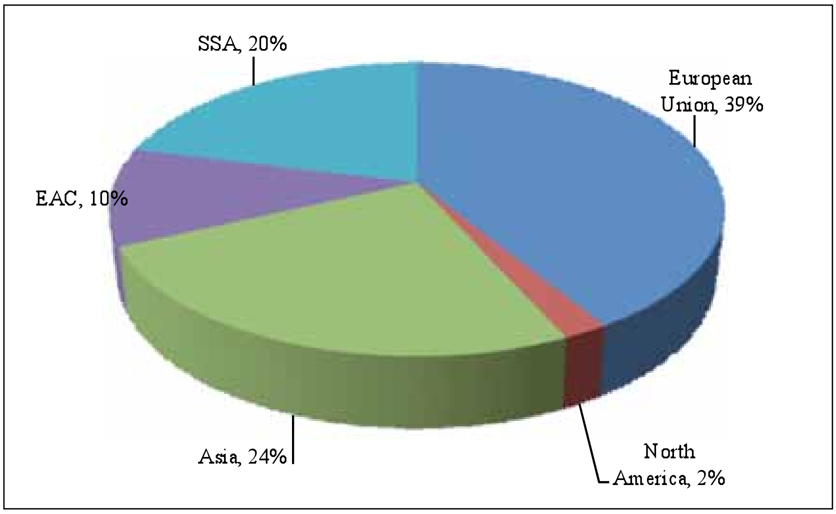
Table 1.2.: Sources of Exports Earnings as Percentage of Total Exports (Years)

	1998	2007	2008	2009	2010
Traditional exports, US$	**30.8**	**8.2**	**9.9**	**10.0**	**9.5**
Non-traditional Exports	**69.2**	**91.8**	**90.1**	**90.0**	**90.5**
Tourism	49.8	33.5	28.0	27.0	24.5
Transportation	5.2	9.3	7.9	7.8	8.4
Manufactured Products	4.5	8.7	16.1	11.8	18.1
Gold	0.4	22.0	24.1	28.6	28.5

Source: Bank of Tanzania

Given the limited integration of Tanzanian financial system with global financial markets, the relevancy of global financial developments to Tanzania is mainly through the international trade channel. Subsequently, whatever happens to Tanzania's trading partners will be reflected in the domestic economy mainly through exchange rate movements, commodity prices, imported inflation, and the trade balance. It is noteworthy that almost 40.0 percent of Tanzanian exports are destined for Europe, while about 24.0 percent goes to Asia **(Chart 1.1)**. Therefore, international developments in these regions may impact on domestic growth momentum, and on balance of payments. On the other hand, Tanzania is an importer of oil which accounts for 25.0 percent of total imports (the highest share for a single item). As such, any international developments that push oil prices up will have a significant impact on inflation, and again on the balance of payments.

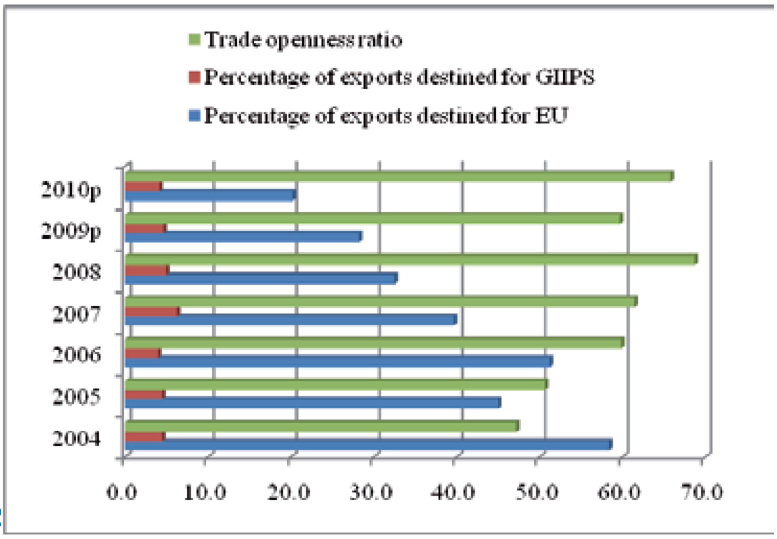
Chart 1.1: Tanzania's exports destination, 2006-2010



Source: Bank of Tanzania

Since the onset of the GFC, the share of Tanzania's exports to EU (a major trading partner) has registered a declining trend from about 52 percent of total exports in 2006 to about 20 percent in 2010 However, the limited exposure of Tanzania's exports to the countries affected by the sovereign debt crisis (GIIPS) – whereby exports to the GIIPS is estimated at around 5 percent, has actually dampened the impact of trade shocks from the Euro-zone **(Chart 1.2)**.

Chart 1.2: Percentage of Tanzania's Exports to European Union



Source: Bank of Tanzania
Note: GIIPS includes Greece, Italy, Ireland, Portugal and Spain.

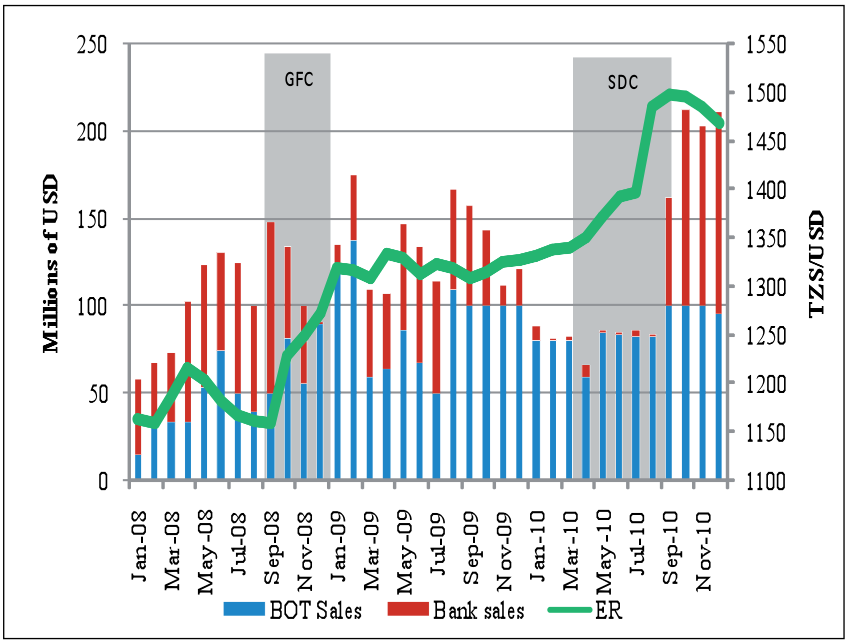
Although, there was a decline in Tanzanian exports to EU, it was offset by an increase in international trade with Asian economies. Tanzania's exports to Asia accounted for 22.5 percent of total exports in 2008, increased to 32.1 percent in 2010. Meanwhile, during the year ending December 2010, exports of Tanzania goods and services destined to various countries, increased at an annual rate of 21.9 percent in December 2010 up from 15.2 percent recorded in 2009 - the improvement is mainly being attributed to the strong economic recovery in the emerging markets and developing Asia.

Another opportunity for Tanzania to improve its external sector performance lies in the recently launched common market protocol in the EAC region, as well as the envisaged capital account liberalization. These moves are expected to have profound impact on widening the scope of domestic demand and attracting capital inflows into the country. The accelerated capital flows to Tanzania will help to finance the widening current account deficit as well as build up in foreign reserves. However, a potentially worrying feature of capital flows is the dominance of the portfolio and debt flows which are prone to sudden stops and reversals. Fortunately, for Tanzania the dominant capital inflows have been the investment flows which are more stable and contribute strongly to sustainable economic growth. It is noteworthy that, as the Bank of Tanzania monitors developments in the external sector and their impact on financial stability, one of the major indicators of potential mitigation against external vulnerability is the level of available level of foreign exchange reserves. By end December 2010, the Bank of Tanzania was able to accumulate foreign reserves amounting to USD 3.9 billion. This level of reserves was sufficient to cover 6.2 months of imports of goods and services, and contributed to enhance the stability of the exchange rate.

1.3.3 Foreign Exchange Markets Developments

During the six months to December 2010, the Shilling depreciated by an average of 5.6 percent against the USD, mainly on account of the strengthening of the USD against other major currencies. However, the increase in donor aid inflows, which came in during the fourth quarter of 2010, helped to ease the pressure on the exchange rate. During the same period, commercial banks also increased their sales of foreign exchange in the IFEM compared to the first half **(Chart 1.3)**.

Chart 1.3: Monthly average Exchange rate obtained in the IFEM



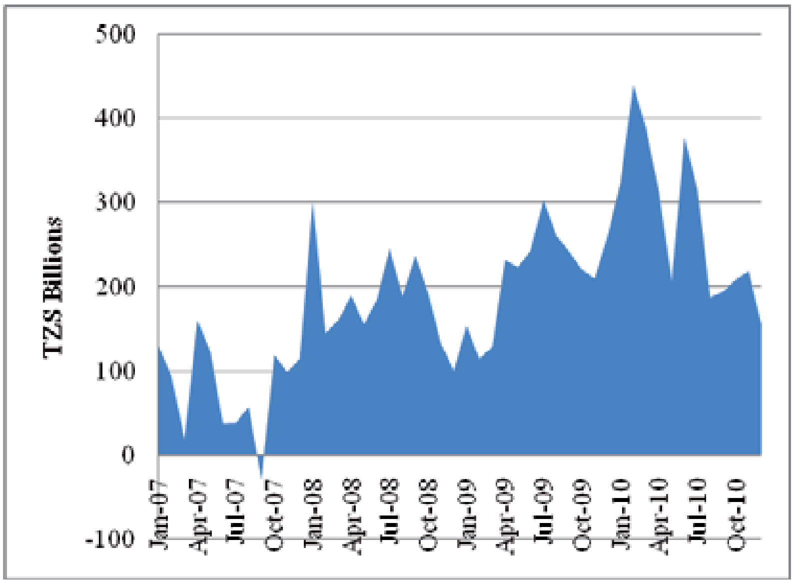
Source: Bank of Tanzania

Going forward, Tanzania like many developing and emerging economies is also anticipating an increase in capital inflows from international investors who are in search of higher returns. However, the capital inflow into Tanzania is not expected to cause currency appreciation due to the fact that the absorption capacity is yet to be exhausted. Nevertheless, the Bank continues to monitor closely the exchange rate and inflation developments for any deviations from the Bank's forecasts and market fundamentals, so as to act accordingly in terms of its monetary policy stance.

1.3.4 Domestic Credit Conditions

In the six months to December 2010, banks have scaled down accumulation of excess reserves that was triggered by the global financial crisis in 2008. Whilst, excess reserves of banks surged from TZS 100.7 billion in December 2008 to a peak of TZS 440.6 billion in February 2010, the level of excess reserves dropped to TZS 154.4 billion by end December 2010 **(Chart 1.4)**.

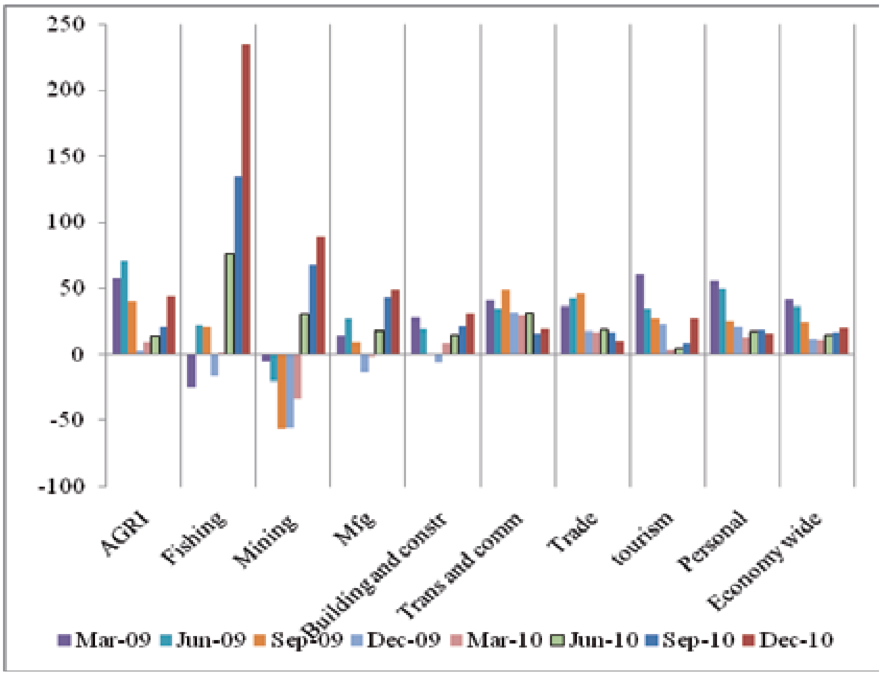
Chart 1.4: Excess Reserves of the Banking System



Source: Bank of Tanzania

The drop in the level of excess reserves and the increase in liquidity squeeze in the banking system especially in the second quarter of 2010/11 is associated with the recorded increase in the flow of credit to private sector, which was triggered by the high demand for cash caused by a bumper harvest. This necessitated the use of the Lombard facility of the Bank of Tanzania, which had not been used in the recent past. In line with the liquidity squeeze, interest rates of all money market instruments increased significantly during that period The annual growth rate of credit to private sector reached 20.0 percent in December 2010, up from the annual growth of 16.3 percent recorded in June 2010. Almost all economic activities recorded positive increments in credit between June and December 2010 **(Chart 1.5)**. Going forward, a further acceleration in credit to private sector is expected, particularly to support the projected economic growth into 2011 and 2012.

Chart 1.5: Quarterly annual growth rate of credit to selected sectors—In Percent



Source: Bank of Tanzania

According to the analysis of sources and uses of funds in the banking system during the year ending December 2010, most banks had increased lending in foreign currency to domestic entities, while investment in risk free assets including government securities and placements abroad declined. As a ratio to GDP, lending to private sector accounted for about 20 percent of GDP at end December 2010, an increase from 16.21 percent recorded in December 2009. This is another indication of the strong rebound of the credit market in Tanzania.

Despite the strong signs of the rebounding credit market in Tanzania, possible threats to the recovery may nevertheless arise from the uncertainties in the recovery of the global, as well as the domestic economy, mainly associated with the rising energy and food prices, and the unfavorable weather conditions. These downside risks to the performance of the economy may elevate risks of declining business profitability and hence increase the potential risks to scheduled debt-service.

2.0 Financial Sector Development

2.1 Performance of the Domestic Financial System

Generally, the Tanzanian financial system remained stable and supportive of economic activities, despite the continuing uncertainties and challenges in the operating environment during the six months under review. During the period, the financial intermediation remained smooth and strong - being supported by an ample liquidity environment and orderly conditions in the domestic financial markets and in the payment and settlement systems.

The contagion risks arising from the global financial developments had negligible impact on the financial sector in Tanzania, due to the low and mostly indirect exposures of financial institutions to counterparties in the global financial markets. Even, parent banking groups have limited access to their Tanzanian subsidiaries' foreign exchange reserves because of the independent nature of their licensing. Foreign banks are registered and licensed as independent legal entities separate from their foreign parent banking groups. This regulatory arrangement limits the exposure of foreign banks from risks arising from the performance of their parent banking groups. Given this background, any potential credit losses in the event of widespread sovereign defaults would also be limited.

The credit risk to the financial institutions emanating from their overseas placements remained limited due the existing prudential regulation system which requires banks to spread their placements according to the credit rating of the foreign banks. In addition, banks are required to monitor their foreign exchange risks, including placements abroad and report to the Bank of Tanzania on daily basis. Parent banking groups have limited access to their Tanzanian subsidiaries' foreign exchange reserves because of the independent nature of their licensing. Foreign banks are registered and licensed as independent legal entities separate from their foreign parent banking groups. This regulatory arrangement limits the exposure of foreign banks from risks arising from the performance of their parent banking groups.

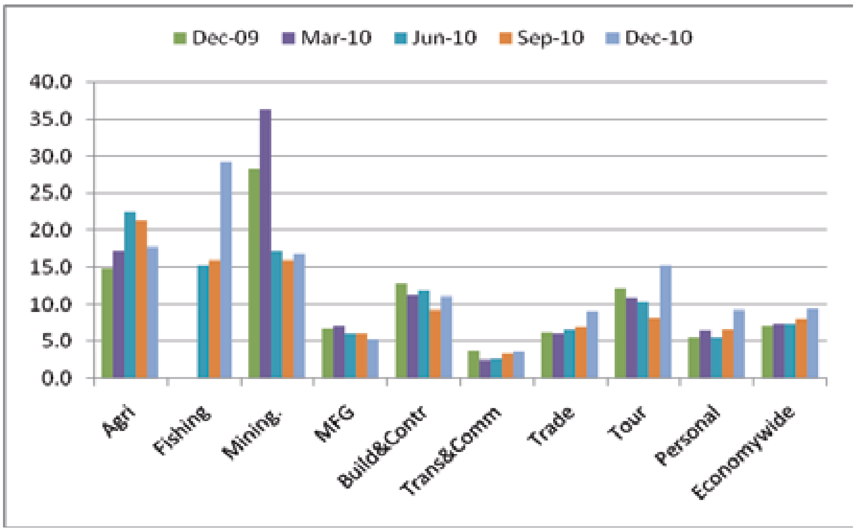
During the period under review, the level of public confidence in the Tanzanian financial services sector remained strong as reflected by smooth operations in the financial system with increasing private sector deposits in banks. The banking sector remained stable and banks were adequately capitalized and liquid. Gross loans and advances increased in December 2010 compared to a year ago, albeit at a moderate pace.

According to the analysis which was carried out using the financial soundness indicators for December 2010 and the results of the stress tests, the banking sector as a whole was well capitalized, sufficiently liquid and resilient to the simulated adverse shocks. The specifics of the monitored soundness indicators are described below.

2.1.1 Capital Position and Asset Quality

The industry ratio of core capital to total risk-weighted assets and off balance sheet exposures was 18.2 percent as of 31st December 2010, which was above the minimum regulatory ratio of 10.0 percent; the ratio of Non-performing Loans to Gross Loans deteriorated to 9.3 percent as of 31st December 2010 from level of 6.7 percent recorded in the previous year. The larger part of the portfolio impairment stemmed from loans to fishing, agriculture, mining and tourism related businesses **(Chart 2.1)**. However, a follow-up examination on key banks revealed that a number of loans granted to sectors that had been affected by the global financial crisis had not been properly classified and provided for as required by the relevant prudential regulations and thus, directed the banks to take appropriate adjustments. At the industry level, the increase in the rate of NPLs did not pose a systemic risk to financial stability and is being addressed by a strong capital buffer held by the industry. Nevertheless, the Bank directed the relevant banks to enhance their credit administration system to mitigate further deterioration of credit portfolios. Moreover, the credit risk on foreign assets emanating from overseas placements remained limited due to the existing prudential regulation system which requires banks to spread their placements according to the credit rating of the foreign banks.

Chart 2.1: NPLs by Economic Activities



Source: Bank of Tanzania

Table 2.1: Financial System Interconnectedness (Top Ten Banks)

Indicators	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
1. Capital Adequacy					
Core Capital/TRWA	18.1	20.2	19.1	19.1	18.2
Total capital/TRWA	18.5	20.5	19.4	19.4	18.9
2. Liquidity					
Liquid Assets/Demand Liabilities	46.5	47.1	46.9	46.9	45.2
Total Loans/Customer Deposits	40.6	40.5	40.8	40.8	40.4
3. Access to Bank Lending					
Claims on non-government sector to GDP	19.4	17.3	18.7	18.7	20.9
Claims on the private sector to GDP	18.5	16.6	17.9	17.9	20.0
4. Earnings and Profitability					
Interest Margin to Gross Interest Income	73.3	73.2	74.8	74.8	75.8
Non Interest Expenses/Gross Income	47.6	53.5	52.5	52.5	54.5
Return on Assets – ROA	3.2	2.7	2.9	2.9	2.1
5. Assets Composition and Quality					
Foreign Exchange Loans to Total Loans	28.9	29.1	32.1	32.1	32.0
Gross Non-Performing Loans to Gross Loans	6.7	7.0	7.2	7.2	9.2
Large Exposures to Total Capital	65.1	93.7	161.5	161.5	104.2
Net Loans and advances to Total assets	46.3	45.2	44.8	44.8	44.1
6. Sensitivity to Market Risk					
Forex Denominated Assets/Total Assets	28.4	27.1	30.0	29.3	30.0
Forex Denominated Liabilities/Total Liabilities	29.7	29.1	30.5	32.0	31.8
Net Open Positions in FX/Total Capital	-11.5	-11.5	3.4	-4.6	-4.4

Source: BOT

2.1.2 Earnings and Profitability

During the year ending December 2010, the banking sector recorded declining profits after tax at the tune of about 18.1 percent. This development is linked to the lower rate of return on assets recorded during the period under review. Specifically, the rate of return on assets dropped from 3.2 percent to 2.1 percent during the year to December 2010. The decline in profitability can partly be explained by the deterioration in asset quality, declining returns on government securities and reduced earnings from foreign placements in line with the declining yields to these investments. The Bank of Tanzania continues to monitor the profitability of the banking sector to ensure that banks take the necessary measures to improve their risk management systems in order to contain, among others, operational risks and improve performance.

2.1.3 Bank Liquidity

The banking sector remained highly liquid. As of 31st December 2010, the ratio of liquid assets to demand liabilities was 45.2 percent - which was above the minimum regulatory limit of 20.0 percent. The high level of liquidity in the banking sector is attributed to a cautionary lending approach adopted by banks, with significant investment in liquid government securities and placement of funds abroad. However, the liquidity of the banking sector is likely going to decline with the growing lending appetite resulting from improving macro-economic conditions.

2.2 Financial System Resilience

The resilience of the Tanzanian financial system continued to be sustained during the reporting period. Conditions in the financial markets and the payment systems remained vibrant, orderly and efficient, thus facilitating the intermediation process in support of the increase in domestic economic activities. The risk-bearing capacity of the financial system to weather the extreme macroeconomic and financial conditions was re-affirmed by the monthly stress tests carried out by the Bank of Tanzania on the banking system – which is the main segment of the financial sector, accounting for 75 percent of financial sector assets.

The scenario-based stress tests, covering both market and credit risk exposures were conducted by the Bank on a monthly basis during the six months under review. During the tests, the Bank assumed a simultaneous materialization of major downside risks to the Tanzanian financial system. The results showed that for the period ending 31st December 2010, the Tanzanian banking system was resilient to adverse changes in interest rates, the exchange rates, as well as in the level of non-performing loans and default of large borrowers in the banking system.

2.3 Measures to Safeguard Financial Stability

Despite the positive outlook in economic and financial environment, the dynamic developments in domestic financial environment may always pose a potential challenge to financial stability. Mindful of the potential risks to financial stability, the Bank remains vigilant in its daily, monthly and quarterly surveillance of the financial system for any early warnings and committed to take pre-emptive measures accordingly. The Bank of Tanzania continues to monitor the soundness of the financial institutions themselves under its existing microprudential supervision regime and requiring the relevant banks to take prompt corrective measures accordingly. Furthermore, the Bank analyses the network structure that banks form due to their various operational interlinkages among themselves which have implications to financial stability. Because of banks' dependency on liquidity provision, interbank loans are among the most vital interconnections between banks. In this regard, banks with excess liquidity provide loans to banks with a demand for liquidity. This interconnection can lead to increased risk sharing in the banking system. It is for this reason that monitoring of systemic risk and potential contagion in the interbank market is an important instrument of maintaining financial stability.

The Bank of Tanzania will continue to ensure that banks' remain prudent in their operations, especially with regard to credit administration and provisioning in order to mitigate credit risk. In addition, the Bank of Tanzania conducts regular examinations on the adequacy of banks' risk management frameworks and internal control functions to ensure business continuity and sustainability. Banks are also required to monitor their foreign exchange risks, including placements abroad and report to the Bank of Tanzania on daily basis.

In a nutshell, the on-site risk based examination of banks continues to be complemented by an off-site surveillance. This stance of enhanced prudential surveillance adopted by the Bank of Tanzania is expected to contribute towards mitigation of any emerging risks to financial sector stability.

The Bank of Tanzania has also enhanced measures to ensure availability of liquidity to the banking system, should the need arise. Specifically, measures to recognize impending liquidity shortfalls have been stepped-up by strengthening daily surveillance of the banking system. Access to emergency facilities at the Bank has been eased to allow commercial banks to have access to these facilities on short notice and at market rates.

Since safeguarding financial stability calls for a macro-surveillance of the financial sector as a whole (at least covering banks, pension and insurance sectors), the Bank will ensure the forum of domestic financial regulators becomes operational soon, in order to facilitate and enhance coordination of regulatory and supervisory initiatives in promoting financial stability.

3.0 Financial Stability Outlook

The outlook of domestic financial stability for the coming six months remains positive and supported by underlying strengths of the Tanzanian financial system as proven by the rigorous stress tests conducted by the Bank on the banking sector during the period ending December 2010. The banking system has accumulated strong financial buffers against the risk weighted assets, as reflected by both the capital adequacy ratios and liquidity levels being above the regulatory minimum requirements. The buffers provide the strength to the financial system to withstand financial risks and domestic challenges, even under extreme credit and market conditions simulated under stress testing.

Meanwhile, shifts in global liquidity in search for higher yielding assets will continue to pose challenges to emerging and developing countries including Tanzania. Although the absorption capacity for Tanzania is still underutilized, large increase in capital inflows may result into higher liquidity levels in the economy. This may cause three main challenges to macroeconomic stability, namely: expectations for the domestic currency to appreciate, inflationary pressures coupled with upward pressures on interest rates. The Bank of Tanzania is well equipped with its prudent monetary policy to deal with this tri-lemma to ensure that the macroeconomic stability enjoyed thus far is sustained. The Bank shall continue to rely on market forces to the fullest possible extent and any actions taken to contain systemic risks shall be at the minimum optional level required to be effective.

GLOSSARY

A Financial System *is made up of three components namely; (i) financial intermediaries (including banks, insurers, pension funds, etc), (ii) financial markets (as alternative sources of finance and as links between financial institutions), and (iii) financial system infrastructures including clearance, payment and settlement, as well as legal, regulatory and supervisory infrastructures.*

Financial stability: *can be defined as a condition in which the financial system is capable of sustaining critical financial services including provision of credit, payment and settlement services and insurance against risks, and be able to withstand shocks on financial intermediation process.*

Financial instability: *can be started by disruptions from within or from outside the financial system. Instability could manifest through banking failures, extreme asset-price volatility or a collapse of market liquidity and disruption in the payment and settlement system. However, disturbances in individual financial institutions need not necessarily constitute financial instability if they do not impair the overall functioning of the financial system.*

Financial stability assessment: *involves a systematic identification and analysis of the sources of risk and vulnerability that could impinge on stability of the financial system as a whole, distinguishing between endogenous sources of risk that are present within the financial system and exogenous sources of risk that might emanate from outside the financial system.*

Systemic Risks: *Are those risks imposed by inter-linkages and inter-dependencies in a system or market, where the failure of a single entity or cluster of entities can cause cascading failures leading to bankruptcies, or bring down an entire financial system or market.*

Macroprudential Policy Framework: *Involves development of appropriate responses to the financial system for safeguarding the stability and efficiency of the financial sector as a whole, rather than focusing on individual institutions or certain economic measures in isolation.*

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