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MONETARY POLICY STATEMENT

The Midterm Review

GOVERNOR
BANK OF TANZANIA

January 2006

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The Hon. Zakia Hamdani Meghji (MP),
Minister for Finance,
United Republic of Tanzania,
Dar es salaam.

Dear Hon. Minister,

LETTER OF TRANSMITTAL

I hereby submit the mid-term review of the Monetary Policy Statement (MPS) of the Bank of Tanzania for the year 2005/06 in accordance with the Bank of Tanzania Act 1995, Section 6 Subsection (1) to (4), as amended in 2003.

The Statement reviews in detail the implementation of monetary policy in the first half of 2005/06, and describes the policy intentions of the Bank of Tanzania for the remainder of the year aimed at consolidating price stability and promoting sustainable growth in the country.

Yours sincerely,

Daudi. T.S. Ballali
Governor
Bank of Tanzania

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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.*

- *Low inflation allows the economy to function more efficiently, thereby contributing to a better overall economic performance.*

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

- *Central Banks control inflation by influencing the growth of money supply. The Bank of Tanzania focuses on the growth of broad money-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 growth of M2, the Bank targets reserve money, which is directly related to money supply through the money multiplier. Reserve money is defined as the liabilities of central bank, which include currency outside the central bank and deposit money banks' reserves held by the central bank.*

MONETARY POLICY IMPLEMENTATION

- *At the beginning of every fiscal year, the Bank of Tanzania sets annual monetary policy targets in its Monetary Policy Statement. 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 of the Bank of Tanzania, chaired by the Governor, closely monitors monetary policy implementation on a 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.*

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

CONTROLLING THE RATE OF INFLATION

- *The objective of monetary policy is to achieve a low and stable rate of inflation.*
- *The Bank of Tanzania focuses on the Consumer Price Index (CPI) to measure inflation. The rate of change in the overall CPI is referred to as the HEADLINE INFLATION RATE.*
- *The inflation rate excluding food prices is often referred to as the NON-FOOD INFLATION RATE. It is a measure of price movements, which are largely influenced by policy factors, but can also be frequently affected by external factors.*
- *The Bank of Tanzania also monitors food prices and their index. This is because food prices are sometimes affected by non-monetary factors like drought and floods, which can affect inflation substantially, regardless of the stance of monetary policy. The rate of change in food price index is referred to as the FOOD INFLATION RATE.*

1.0 INTRODUCTION

1.1 The Bank's Primary Mission

The Bank of Tanzania gives top priority to the maintenance of monetary stability, which in turn leads to low inflation - a prerequisite for sustainable high rate of economic growth. Sustainable high rate of growth over the long run is necessary for improving the living standards of Tanzanians.

The primary responsibility of the Bank of Tanzania as stated in the Bank of Tanzania Act is to formulate and implement monetary policy that generates low and stable inflation over time. Low and stable inflation enhances confidence in the value of money, thus facilitating mobilization and efficient allocation of resources in the economy. The long-term objective of monetary policy of the Bank of Tanzania is to achieve an annual inflation rate, which is close to the average rate of inflation of Tanzania's major trading partners. For the last five years major trading partners have been the Euro Zone, United Kingdom, South Africa, India, Japan, Kenya, United States of America, China and United Arab Emirates. The average inflation rate for the nine major trading partners was 4.4 percent in 2004.

1.2 Central Bank Policy Objectives

In conducting monetary policy, the Bank of Tanzania seeks to achieve:

(i) A gradual and acceptable rate of increase in the money supply consistent with the demands of the economy, without compromising the macroeconomic stability and the inflation objectives

(ii) A rate of increase in domestic bank credit which is consistent with the monetary policy objectives

(iii) Market determined interest rates

(iv) A level of official foreign reserves sufficient to enable the Bank to meet import requirements, external payments obligations, and unexpected foreign exchange requirements in times of Balance of Payments need

(v) A relatively stable and realistic exchange rate

(vi) A sound, and well managed banking system; and

(vii) Well functioning financial markets, as well as an efficient payments, clearing and settlement systems.

2.0 MONETARY POLICY FRAMEWORK FOR 2005/06

2.1 Monetary Policy Objectives for 2005/06

The overall macroeconomic objectives of the Government of Tanzania for 2005/06, are the following:

i. A real GDP growth of 6.9 percent in 2005 and 7.0 percent in 2006;
ii. To maintain the inflation rate at 4.0 percent until end- June 2006;
iii. Domestic recurrent revenue equivalent to 13.8 percent of GDP;
iv. Overall budget deficit of 7.2 percent of GDP, with Government domestic borrowing targeted at 1.1 percent of GDP; and,
v. Maintaining minimum official foreign reserves equivalent to six months of imports of goods and services.

The Bank of Tanzania monetary policy objectives for 2005/06 were consistent with the above macroeconomic objectives. The Bank's monetary policy aimed at: -

i. Containing the expansion of reserve money (M0) at 26.6 percent between end-June 2005 and end-June 2006;
ii. Limiting the growth rates of both broad money supply,

M2 and extended broad money, M3 at 27 percent by end June 2006;

iii. Mainitaining an inflation rate of about 4 percent until end-June 2006;

iv. Allowing commercial banks credit to the private sector to grow by an annual rate of 33 percent by end-June 2006; and,

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

3.0 REVIEW OF MONETARY POLICY IMPLEMENTATION DURING JULY-DECEMBER 2005

An Overview

Significant achievements have been recorded on the monetary policy front over the last six months, which helped to contain inflationary pressures and maintain monetary stability. Nevertheless, the persistent increases in oil prices, and emerging food shortages stemming from the delayed and below average rainfall in most areas of the country during the last half of 2004/05 and the first half of 2005/06, have began to exert upward pressure on inflation and could pose a threat to the maintenance of the current status of macroeconomic stability, particularly the inflation target for 2005/06. After having successifully kept the inflation close to 4 percent, it began inching upward each month from 4.2 in June to the annual inflation rate of 5.0 percent in December 2005.

In response to the emerging inflationary pressures, the Bank of Tanzania adopted a tighter monetary policy stance during the second quarter of 2005/06 in order to curtail the rate of increase. Given the drought and continued high oil prices, the annual inflation target of 4.0 percent by June 2006 will be difficult to achieve.

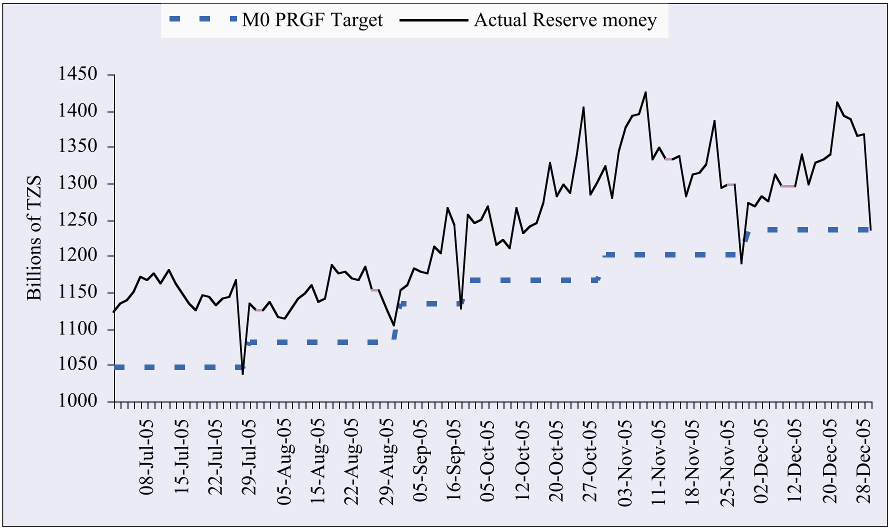
3.1 Liquidity Management

The first half of 2005/06 witnessed a considerable build up of excess liquidity in the economy, mainly coming from previous year's government expenditure float that was above the projections, unanticipated expenses related to postponed elections, salary increases and payment of retirement benefits for EAC retirees. The situation was exacerbated by a sizeable shortfall (USD 176.8 million) in donor funds inflows, which forced the government to draw down its deposits in the banking system in order to finance the resulting expenditure gap.

Amidst these developments, the economy registered excess liquidity above the targeted levels, as reflected by the persistent increase in reserve money above projections. On average during the past six months, reserve money exceeded its monthly targets by about TZS 94 billion **(Chart 3.1)**.

Against this background, the Bank scaled up its efforts to reduce the excess liquidity in the economy through increased sales of treasury bills, and foreign exchange, and conducting more repurchase agreements with commercial banks. The tender size for treasury bills was steadily enhanced from TZS 48.6 billion per week offered during July 2005 to TZS 70 billion during December 2005. This move exerted upward pressure on Treasury bills interest rates. The weighted average yield for treasury bills moved from an average of 10.4 percent in July 2005 to 14.8 percent in December 2005.

Chart 3.1: Developments in Reserve Money



At the same time, while repurchase agreements (repos) worth TZS 72.2 billion were conducted in June 2005, repos worth TZS 101.8 billion had to be conducted in September 2005, and TZS 31.8 billion were concluded in December 2005. The Bank of Tanzania sales of foreign exchange in the inter-bank foreign exchange market between July and December 2005, on net basis, amounted to USD 255 million, which led to the absorption of TZS 294.9 billion from the economy, compared to USD 59.8 million sold during the corresponding period of 2004.

The above monetary policy measures combined with increased government revenue collections that exceeded targets during the period under review, enabled the Bank to attain most of the targets of the Poverty Reduction and Growth Facility (PRGF) programme quantitative benchmarks and performance criteria set for the period under review.

Table 3.1: Tanzania: Summary of PRGF Targets and Outturn (Billions of TZS)

	Jun-05 Benchmark			Sep-05 Performance Criteria			Dec-05 Benchmark		
End of Period†	Program	Adjusted Program	Actual	Program	Adjusted Program	Actual	Program	Adjusted Program	Actual
NDF	157.0	188.0	144.9	-101.0	191.2	110.3	-144.0	61.5	-35.0
NDA	-776.0	-745.0	-749.0	-894.0	-601.8	-578.2	-963.0	-757.5	-539.5
M0	1028.0	1028.0	1028.0	1133.0	1133.0	1128.1	1235.0	1235.0	1236.1
NIR (Mill. of USD)	1589.0	1562.0	1567.3	1763.0	1505.7	1615.1	1921.0	1744.2	1676.2

3.2 Credit Policy

The Bank of Tanzania current credit policy aims at increasing the flow of credit to the private sector. The strategy used is to encourage the government to reduce its budget deficit and therefore its borrowing requirements, and thus leave room for domestic financing of private productive sector. During the period under review, net claims on government by the banking system were reduced from TZS 284.6 billion as at end June 2005 to TZS 251.1 billion by end December 2005. As a consequence, it was possible to increase credit to private sector by an average annual growth rate of 32.5 percent from TZS 1,219.4

billion in June 2005 to TZS 1,425.1 billion in December 2005.

3.3 Interest Rate Policy

The Treasury bill market continued to be the anchor for market determined interest rates. During the review period, interest rates on Treasury bills moved upwards as a result of intensified sales of government securities in pursuit of tight monetary policy. Although, the upward trend in Treasury bill rates influenced a similar pattern on interest rate structure in banks, rigidities in the banking system continued to affect developments in interest rates charged by commercial banks and non-bank financial institutions.

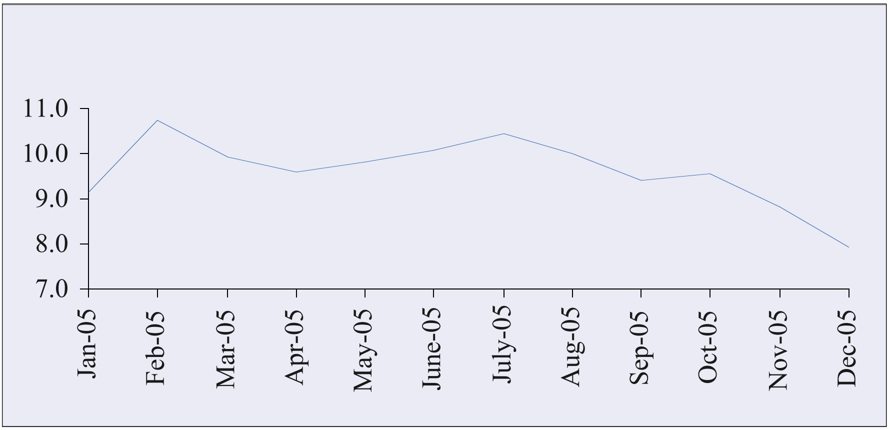
The overall Treasury bill rate moved sharply up from an average of 9.30 percent in June 2005 to 14.78 percent in December 2005. In tandem, the weighted average rate for time deposits rose from 4.41 percent to 5.28 percent, while average lending rate was maintained at around 15 percent throughout the period under review.

On the other hand, the average negotiated lending rate was maintained at around 11 percent, while the average negotiated deposit rate rose from 8.49 percent to 10.61 percent between June and December 2005. Given that the inflation rate was below 5 percent during the period under review, negotiated deposit rates were all positive in real terms.

During the period under review, the interest rate differential between

12-month time deposit rate and 1-year lending rate narrowed from 10.09 percentage points in June 2005 to 7.91 percentage points by end-December 2005 (**Chart 3.2**). This has improved prospects that the interest rates will be responsive to envisaged developments in the financial markets, a development that will enhance financial intermediation.

Chart 3.2: Spread Between 12-month Time Deposit Rate and Short-term Lending Rate



3.4 Foreign Exchange Operations

Foreign exchange operations during the review period were guided by the need to achieve a stable market determined exchange rate and build up foreign exchange reserves, so as to attain the equivalent of at least six months of imports by end June 2006.

During the period under review, there was a substantial increase in the demand for foreign exchange to finance imports of goods and services. The surge in the demand for foreign exchange was mainly attributed to a hike in importation of capital goods to meet the needs of the growing economy and oil for thermal power generation.
During the period from July 2005 to December 2005, the Bank of Tanzania sold USD 255 million on net basis, in order to fill the foreign exchange supply gap in the Inter-bank Foreign Exchange Market (IFEM)

Despite the substantial sale of foreign exchange, the Bank increased its gross international reserves. The level of official gross international reserves went up from USD 1,968.6 million equivalent to 7.5 months of imports in June 2005 to USD 2,048.4 million (7.8 months of imports) by end December 2005.

4.0 REVIEW OF MACROECONOMIC DEVELOPMENTS DURING THE FIRST HALF OF 2005/06

4.1 Inflation Developments

The food shortage caused by inadequate rainfall in most parts of the country, combined with rising oil prices exerted substantial pressure on the rate of inflation during the review period. High food prices together with increasing oil prices pushed the annual headline inflation rate above the targeted 4 percent. In June 2005, the **annual** headline inflation rate was 4.2 percent, which inched up to 5.0 percent by December 2005. The upward movements were mainly driven by rising food prices, which placed food inflation at 5.8 percent in June 2005, and at 7.2 percent in December 2005.

Non–food inflation increased at a much slower pace from 3.0 percent in June 2005 to 3.6 percent in December 2005. The upward trend of inflationary pressure necessitated the Bank of Tanzania to adopt a tighter monetary policy stance during the period under review, and will continue with the same stance during the remaining period of 2005/06, in order to safeguard the macroeconomic stability gains already achieved.

4.2 Food Supply Situation

Food production during the short rains season (vuli) normally accounts for about 25 percent of total national food production in any given year. According to preliminary estimates by the Ministry of Agriculture, Food Security and Cooperatives, the impact of the delayed and inadequate short rains received during 2005 could result in a decline of more than 50 percent in food production during the Vuli season. The government has started to take measures to ensure availability and affordability of food in about 34 districts, which are facing food shortages.

At the end of December 2005, the total food grains stock was 245,573 tons of cereals. Out of this, SGR stock posted 93,051 tons of maize, while registered private traders had 152,522 tons in stock, comprising 53,744 tons of Maize, 15,149 tons of rice and 83,629 tons of wheat. The total cereal stock at 245,573 tons is considered inadequate to meet the national cereal requirements. Consequently, cereals will have to be imported to meet the shortfall in domestic production.

During the period under review, the Government purchased 10,000 tons of maize from SGR department for distribution to deficit districts. The Government is further arranging to purchase another 11,000 tons of maize during the third quarter of 2005/06 to cater for the requirements of drought-affected areas.

4.3 Monetary Developments

During the review period, the Bank focused on achieving the targets for reserve money in order to align the growth of money supply to macroeconomic objectives for 2005/06. Extended broad money (M3) increased from a stock of TZS 3,266.4 billion at end June 2005 to TZS 3,927.3 billion at end December 2005, while broad money supply (M2), which excludes foreign currency deposits, rose from TZS 2,366.4 billion to TZS 2,801.5 billion during the same period. On average, the annual growth rates of M3 and M2 were 30.2 percent and 30 percent, respectively during the period under review, slightly exceeding the targeted growth rate, due to excess liquidity in the economy, arising from increased foreign exchange inflows and increased demand for money.

4.4 Domestic Credit Developments

The Bank continued to implement its monetary policy in a manner that would accommodate an annual growth of 33 percent of credit to the private sector, necessary to achieve the targeted GDP growth of 6.9 percent in 2005 and 7 percent in 2006.

During the past six months, private sector credit grew at an average annual rate of 32.5 percent, which is in line with the envisaged momentum of economic activities. The outstanding stock of private sector credit increased from TZS 1,219.4 billion at end June 2005 to TZS 1,425.1 billion by end December 2005.

The major factors behind the strong growth of credit to private sector include among others, the strong economic expansion during 2005 coupled with an increase in the number of credit worthy clients following improvement in the business environment, including privatisation of former state owned firms. The existence of credit guarantee schemes for exporters has also helped accessibility to credit.

Table 4.1: Tanzania: Developments in Selected Monetary Aggregates (Billions of TZS)

	2004		2005		Absolute Change		Annual % Change	
	Jun	Dec	Jun	Dec	Jun-Dec 2004	Jun-Dec 2005	Jun-05	Dec-05
Extended broad money (M3)	2602.9	2848.1	3266.4	3927.0	245.2	660.9	25.5	37.9
Broad money (M2)	1856.3	2050.9	2366.4	2801.5	194.6	435.1	27.5	36.6
Currency in circulation	590.4	664.1	734.9	843.2	73.7	108.3	24.5	27.0
Demand Deposits	595.6	651.6	793.9	908.9	56	115.0	33.3	39.5
Time deposits	269.1	276.4	328.7	422.3	7.3	93.6	22.1	52.8
Savings Deposits	401.1	458.8	509	627.2	57.6	118.2	26.9	36.7
Foreign currency deposits	746.6	797.2	900	1125.8	50.6	225.8	20.5	41.2
Net Foreign Assets	2134.2	2379.9	2279.3	2407.3	245.7	128.0	6.8	1.2
Bank of Tanzania	1468.9	1715.3	1666	1626.9	246.4	-39.1	13.4	-5.2
Deposit Money Banks	665.3	664.6	613.3	780.4	-0.7	167.1	-7.8	17.4
Net Domestic Assets	962.9	932.5	1511	2129.2	-30.4	618.2	56.9	128.3
Domestic Credit	1123.6	1012.4	1504	1676.2	-111.2	172.2	33.9	65.6
Claims on Government	515.2	477.6	551.1	887.5	-37.7	336.4	7.0	85.8
Government Deposits	357.6	525.3	266.5	636.4	167.6	369.9	25.5	21.2
Claims on the private sector	966	1060.1	1219.4	1425.1	94.1	205.7	26.2	34.4
Other Items Net	-160.7	-79.8	7	453.0	80.9	446.0	-104.4	-667.7
Medium Term Foreign Liabilities	41.1	39.1	39	34.7	-2.1	-4.3	-5.3	-11.1
Valuation Account	453	425.3	484.9	574.5	-27.8	89.6	7.1	35.1

Source: Bank of Tanzania.

4.5 Government Budgetary Performance

During 2005/06, the Government's fiscal policy aims at improving tax administration so as to enhance tax revenue performance, and improve expenditure management to maintain fiscal sustainability. Revenue collected between July and December 2005, amounted to TZS 1,046.8 billion, being above the target by TZS 24.3 billion. The higher revenue collection is the outcome of the on going efforts in improving tax administration system, and close monitoring of taxpayers compliance.

With regard to expenditure, the Government continued to give priority to projects that facilitate the achievement of the National Strategy for Growth and Reduction of Poverty (MKUKUTA) objectives. During the review period, total expenditure amounted to TZS 2,030.2 billion, which was within the budgeted expenditure of TZS 2,041.8 billion.

During the first half of 2005/06, the overall budgetary performance (on cheques issued basis) recorded a deficit of TZS 983.5 billion, before grants. The overall deficit was TZS 374.4 billion after considering grants amounting to TZS 609 billion. The deficit was financed from both bank and non bank sources.

4.6 External Sector Developments

During the first half of 2005/06, the current account deficit widened substantially to USD 375.2 million from a deficit of USD 26.8

million recorded in the corresponding period a year earlier. The poor performance in the current account was mainly attributed to slow disbursements of official foreign assistance from development partners, that went down to USD 386.1 million from USD 529.8 million recorded in July – December 2004. Moreover, scheduled interest payments of USD 105 million were made as against USD 65 million paid during the previous corresponding period.

Table 4.2: Tanzania's Current Account (Millions USD)

	July-December		
	2004	2005p	% Change
Goods Account (net)	-502.2	-640.9	27.6
Exports	786.9	803.6	2.1
Imports	1289.1	1444.5	12.1
Services Account (net)	-31.4	-44.1	40.6
Receipts	541.4	567.5	4.8
Payments	572.8	611.6	6.8
Goods and services (net)	-533.6	-685.0	28.4
Exports of goods and services	1,328.3	1,371.1	3.2
Imports of goods and services	1,861.8	2,056.2	10.4
Income Account (net)	-24.6	-71.3	--
Receipts	40.2	33.9	-15.9
Payments	64.8	105.1	62.1
Current Transfers (net)	531.4	381.0	-28.3
Inflows	564.8	421.7	-25.3
o/w General Government	529.8	386.1	-27.1
Outflows	33.4	40.6	21.7
Current Account Balance	-26.8	-375.2	--

Source: Bank of Tanzania
p Provisional

During July - December 2005 period, the deficit on trade account increased as the value of exports increased only by 3 percent, while that of imports went up by 10 percent. As a result, the trade account deficit widened to USD 685 million compared with USD 534 million recorded for the same period a year earlier.

Exports

During July - December 2005, Tanzania exported goods and services worth USD 1,371.1 million, up from USD 1,328.2 million registered in the corresponding period in 2004. The increase in exports resulted from good performance in tourism and non-traditional exports, particularly mineral exports; manufactured goods exports, fish and horticultural products.

Between July and December 2005, mineral exports amounted to USD 351 million, out of which gold exports were USD 322.4 million. Manufactured goods exports, on the other hand, earned USD 91.6 million, while fish earned USD 68.5 million; horticultural produce earned USD 8.4 million, and traditional exports - coffee, cotton, cashewnuts, tea, tobacco, sisal and cloves earned a total of USD 189.4 million. The performance of cotton, coffee, and tobacco improved slightly during the review period compared to previous year's performance, while that of tea, cashewnuts, cloves and sisal was poor.

Imports

During July-December 2005, imports of goods and services stood at USD 2,056.2 million, being an increase of USD194.4 million above the level recorded in 2004. The increase in imports was associated with the expansion of economic activities in the country, particularly in the mining, construction, tourism and manufacturing sectors, and also due to the increase in consumer goods imports.

Imports of capital and intermediate goods rose from USD 135.8 million in July 2005 to USD 172.8 million in December 2005. Similarly, consumer goods imports went up from USD 48.1 million to USD 66.6 million.

4.7 Foreign Exchange Operations and Exchange Rate Movement

Between July and December 2005, the volume traded in the IFEM was USD 492 million compared to USD 545.8 million traded during the corresponding period in 2004. During 2005, the volume traded in the IFEM declined to USD 738.5million from USD 979.4 million traded in 2004.

The Bank of Tanzania intervened occassionally in the foreign exchange market as a supplier/buyer of last resort in order to complement open market operations for liquidity management. During the period under review, the Bank sold on a net basis, USD 255 million between July and December 2005, compared with a net sale of USD 59.8 million during the same period last year.

In line with developments in the supply and demand of foreign exchange in the market during the review period, the shilling depreciated slightly in nominal terms against the USD to an average of TZS 1,161.88 per USD by December 2005, from an average of TZS 1,116.64 per USD in June 2005. The shilling however appreciated slightly against currencies of its main trading partners as their currencies experienced greater depreciation against the USD.

4.8 National Payment Systems (NPS)

The Bank of Tanzania continued implementing measures aimed at modernising National Payment Systems. Specifically, the Bank continued to maintain and support the existing payment systems, particularly the Tanzania Inter-bank Settlement System (TISS), cheques clearing system, and the inter-bank electronic fund transfer system. The Bank also facilitated development of new non-cash payment infrastructure including ATM systems and other services being introduced in the market. Currently, there are 123 Automatic Teller Machines (ATMs) in the country, servicing over 400,000 customers.

Furthermore, the Bank continued to coordinate reforms in the payment systems institutional framework aimed at mitigating operational risks and harmonisation of payment systems as agreed in East African Community and SADC fora.

4.9 Micro-finance

During the period under review, the Bank of Tanzania coordinated the preparation of draft regulations for community and member based micro-finance institutions under the Banking and Financial

Institutions Act of 1991. The final draft regulations were submitted to the Minister for Finance in December 2005 for consideration.

As one of its subsidiary responsibilities, the Bank of Tanzania provided the general public with basic information on developments in financial sector, including information on micro-finance institutions. The Bank established during the review period, the Micro-finance Web page www.bot-tz.org/MFI/, which is linked to the BOT Website. The Micro-finance Web page enables to disseminate to stakeholders and the public, micro-finance information collected from inside and outside the country.

Furthermore during the review period, the Bank conducted a nation-wide survey to update the Directory of Micro-finance Institutions prepared in 2002. The survey took stock of government assistance and donor support to the micro-finance sector.

5.0 MONETARY POLICY IMPLEMENTATION FOR THE SECOND HALF OF 2005/06

5.1 Liquidity management

During the second half of 2005/06, the Bank of Tanzania intends to continue implementing monetary policy that is consistent with the Government's macroeconomic objectives for 2005/06. The major objective during the remainder of the fiscal year will be to ensure that growth of monetary aggregates remains within targets. The monitoring of reserve money will be central in controlling liquidity in the economy to ensure that it stays within desired levels.

In view of the expected large foreign exchange inflows arising primarily from donor funding during the remainder of the year, and the recent increase in the demand for money, daily liquidity tracking will be strengthened. In doing so, market distortions will be avoided, notably in Treasury Bills Market, as well as in the Inter-bank Foreign Exchange Market.

The Bank will conduct timely and targeted sterilization operations by selling Treasury Bills, supplemented by sales of foreign exchange and *repo* transactions.

During January – June 2006, the Bank will lower substantially the minimum Treasury Bills and Bonds bid amount from the current TZS 50 million threshold in order to widen participation of direct investors in the Treasury bills market. This move is expected to increase competition and hence lower interest rates on debt instruments.

5.2 Credit Policy

The Bank's policy on credit will continue to be directed towards providing credit to the private sector, while ensuring that it stays within the targeted growth by June 2006. To enhance the flow of credit to private sector, the Bank will continue collaborating with the Government in implementing measures to remove the remaining structural and institutional impediments, aimed at deepening financial intermediation. The Bank will also facilitate operationalization of credit reference bureau in order to provide quick reference on credit worthiness of potential borrowers.

During the coming six months, various measures will be taken by the Government in order to facilitate provision of credit to various economic ventures. The increase in funding for the existing credit guarantee schemes during the 2005/06 budget has enhanced the flow of credit to private businesses, including small and medium scale economic ventures.

5.3 Interest Rate Policy

During the remainder of the year, efforts by the Bank will be directed towards increasing efficiency in the money markets, so as to lower the cost of intermediation and allow interest rates move to realistic levels and remain positive in real terms. The Bank will enhance competition in the Treasury bills market to ensure that yields are stable and predictable.

The Bank notes that although the gap between deposit and lending rates have been narrowing, the current spread is still wide due to impediments in the economy, including the high cost of intermediation and the perceived high risks associated with lending to private sector. However, the situation could improve during the coming six months, in view of the expected enhanced competition in the market following removal of restrictions to lend, imposed on the National Microfinance Bank (NMB) prior to privatization.

5.4 Foreign Exchange Operations

The Bank of Tanzania will continue with its measures to strengthen the IFEM during the second half of 2005/06. The Bank's intervention in the market will continue to be limited to smoothening short-term supply and demand fluctuations in the foreign exchange market, while meeting the foreign exchange needs in the economy and servicing government external debt obligations as they fall due.

6.0 CONCLUSION

Developments in major macroeconomic indicators during July-December 2005 period, were broadly in line with projections, demonstrating the effectiveness of the combined fiscal and monetary policy measures being implemented to achieve macroeconomic objectives. However, the Bank of Tanzania foresees major challenges ahead posed by the prolonged drought, leading to food shortages, and the continued high oil prices. The combination of these shocks has adverse implication on inflation and growth. There is a need therefore for fiscal restrain during the remainder of the fiscal year, while taking into account the need to provide adequate resources to accomodate the required food imports.

The projected foreign exchange inflows during the remainder of the year, coupled with inflationary pressures emanating from rising oil and food prices call for a futher tightening of monetary policy. In addition to the remaining structural problems in the economy which have contributed to the maintenance of wide margins between deposit and lending rates, the expansionary fiscal stance during the first half of the fiscal year need to be reversed.

To this end, close coordination between monetary and fiscal policies need to be enhanced, so as to address the challenges, and in order to attain the macroeconomic objectives of the Government for the year 2005/06 as a whole.

APPENDICES

Table 1: Percentage Change in Consumer Price Index (All-Urban)

Base: 2001=100)

	Year-on-Year			Month-on-Month		
	Headline Inflation	Non- Food Inflation	Food Inflation	Headline Inflation	Non- Food Inflation	Food Inflation
2003 -Jan	3.4	3.3	3.4	5.4	5.0	5.5
Feb	3.4	2.1	4.4	-0.5	-0.8	-0.3
Mar	3.4	2.9	3.7	-0.8	-1.1	-0.6
Apr	3.4	1.7	4.7	-0.2	-0.1	-0.2
May	3.6	1.6	5.0	-0.2	-1.5	0.7
Jun	3.6	0.8	5.6	-0.3	-0.7	0.0
Jul	3.5	3.0	3.9	0.8	2.8	-0.4
Aug	3.5	2.0	4.4	-0.5	-0.9	-0.3
Sep	3.7	1.4	5.2	0.3	-1.1	1.2
Oct	3.6	2.2	4.6	-0.3	0.8	-0.9
Nov	3.4	1.6	4.7	-0.5	-0.6	-0.6
Dec	3.4	1.4	4.8	0.3	-0.3	0.7
2004- Jan	3.6	0.2	6.0	5.6	3.8	6.7
Feb	3.8	0.2	6.6	-0.3	-0.8	0.3
Mar	4.0	-0.1	7.0	-0.5	-1.4	-0.2
Apr	4.7	-0.5	8.4	0.5	-0.5	1.1
May	4.4	2.0	6.0	-0.5	1.0	-1.5
Jun	4.2	3.1	4.9	-0.5	0.4	-1.1
Jul	4.1	1.8	5.3	0.7	1.4	-0.1
Aug	4.1	1.5	5.9	-0.5	-1.2	0.4
Sep	4.0	3.2	4.6	0.2	0.6	-0.1
Oct	4.2	2.5	5.2	-0.1	0.1	-0.3
Nov	4.4	2.4	5.9	-0.3	-0.7	0.1
Dec	4.2	2.9	5.1	0.1	0.2	-0.1
2005 -Jan	4.0	1.5	5.9	5.4	2.4	7.5
Feb	4.1	1.8	5.7	-0.2	-0.5	0.1
Mar	4.1	3.3	4.9	-0.5	0.0	-0.9
Apr	4.0	3.9	4.3	0.4	0.2	0.5
May	4.0	3.0	5.0	-0.5	0.1	-0.8
Jun	4.2	2.5	5.8	-0.3	0.0	-0.3
Jul	4.4	2.0	7.0	0.9	0.8	1.1
Aug	4.5	3.6	5.8	-0.4	0.3	-0.8
Sep	4.5	2.8	6.0	0.2	-0.1	0.2
Oct	4.7	2.8	6.7	0.1	0.0	0.3
Nov	4.8	3.7	6.7	-0.2	0.2	0.1
Dec	5.0	3.6	7.2	0.3	0.1	0.4

Source: National Bureau of Statistics

Chart 1: Tanzania: Annual Headline, Food, Non-food inflation

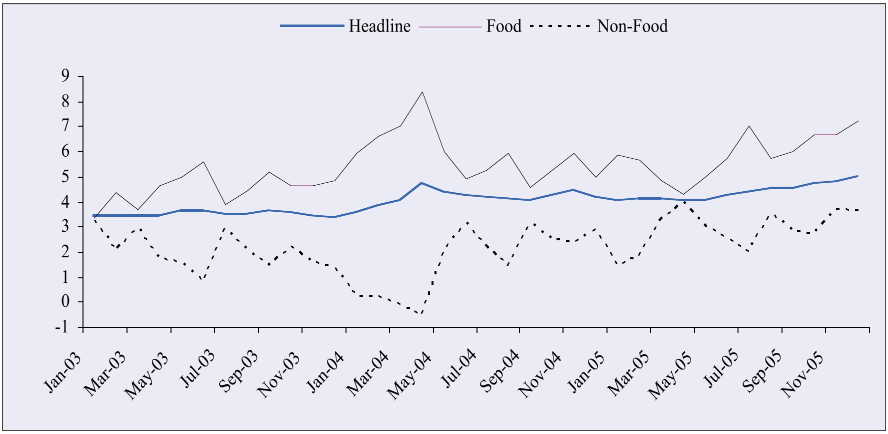


Chart 2: Tanzania: Annual Growth Rates of Monetary Aggregates

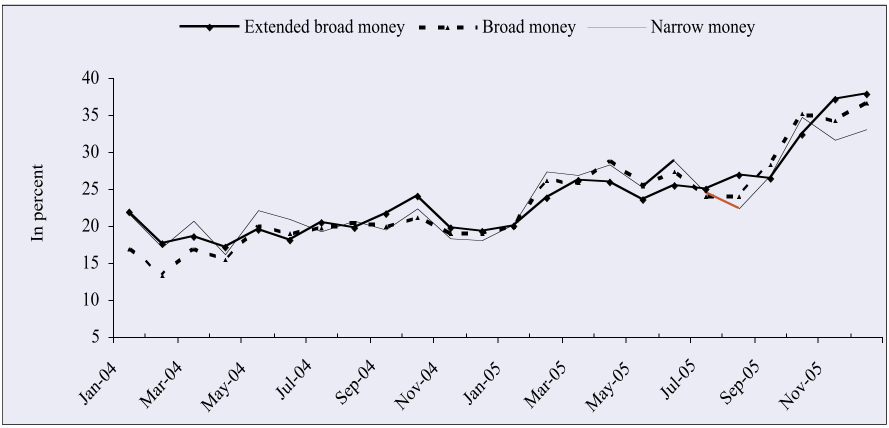


Chart 3: Tanzania: Components of Money Supply (In percentage of Total Deposits)

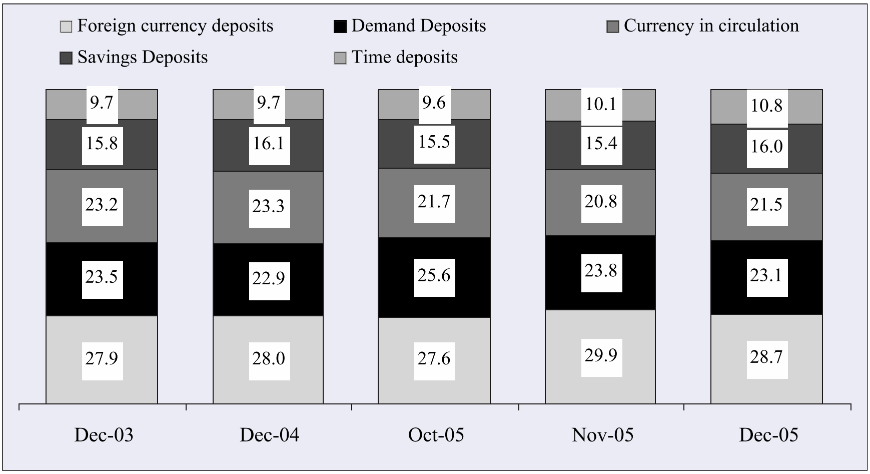
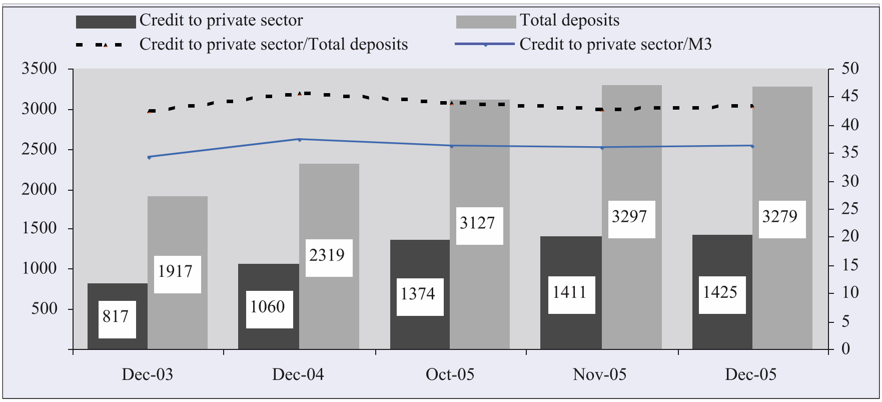


Chart 4: Tanzania: Commercial Banks Intermediation (In billions of TZS)



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 USD.

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 35 -, 91-, 182-, and 364 - day Treasury Bills, expressed in percent per annum.