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Dr. F. M. Mlozi,  
Secretary,  
Banking Commission,  
P.O. Box 2939,  
Dar es Salaam,  
Tanzania

RHG/SH

7th February 1990  
By DHL Courier

Service

Dear Dr. Mlozi,

Here are all your memos except Public Finance. As you see I have chosen to respond to issues more than to other papers. Public Finance will follow but I fear in about 2 weeks.

Best of luck

A handwritten signature in black ink, consisting of a large, stylized letter 'R' followed by a long horizontal stroke.

Reg Green

P.S. Public Finance is too thin while the Monetary Policy paper is 'academic' in bad sense.

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INVOICE NO. 318251  
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 Date: 7 February 1990

To:

Dr. F. M. Mlozi  
 Banking Commission  
 P.O. Box 2939  
 DAR ES SALAAM  
 Tanzania

To: Dispatch by Courier Service of 8 memos  
 on Financial Sector Restructuring -  
 By R. H. Green

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ISSUE REF

S. Hill

INVOICE NO. 318251



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Nd. Joan Wicken,  
P. O. Box 9151,  
Dar es Salaam,  
Tanzania

RHG/SH

7th February 1990

Dear Joan,

Here are Financial Sector Reconstruction Paper set I've done for CD and Banking Commission. You and Chairman may find interesting. Good to see you in Geneva.

Cordially,

A handwritten signature in black ink, consisting of a large, stylized letter 'R' followed by a long horizontal stroke that tapers to the right.

Reg Green



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The Hon C. D. Msuya, MF, MP,  
Ministry of Finance & Planning  
Hazina,  
Box 9111,  
Treasury Building,  
Madaraka Avenue,  
Dar es Salaam,  
Tanzania

RHG/SH

7th February 1990

Dear Cleopa,

Here are an inter-related set of memos on Financial Sector Restructuring.  
They are triggered by requests of Dr. Mlozi of Banking Commission but I  
think you and your people will find them useful.

Cordially,

A handwritten signature in black ink, appearing to be 'Reg Green', written over a horizontal line.

Reg Green



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H.E. Amir Jamal,  
Ambassador,  
Embassy of the United  
Republic of Tanzania,  
47 Avenue Blans,  
1202 Geneva,  
Switzerland

RHG/SH

7th February 1990

Dear Amir,

Sorry to miss you again in Geneva. Glad to hear you are feeling better. Hope Joan passed on my regards. The enclosed are a set of papers on Financial Sector Reconstruction I've done for CD and Banking Commission. Any comments (to me or, perhaps more to the point, to them) very welcome.

Cordially,

A handwritten signature in dark ink, consisting of a large, stylized 'R' followed by a long horizontal stroke that tapers to the right.

Reg Green

PUBLIC FINANCE: Analysis of Imbalance  
and Non Destructive Ways Forward

By R. H. Green

A. Introduction and Overview

1. There is a structural imbalance between recurrent expenditure - including debt service and subsidies - and domestic revenue.
2. This is wholly a post 1977 phenomenon. Dips toward recurrent deficits in the mid-1960s and into one (nominally - adjusted for debt retirement oddly classed as recurrent, 1974/75 still had a recurrent surplus) in the mid-1970s were quickly reversed by policy as well as exogenous favourable events (1966 weather and 1976 coffee booms).
3. Contrary to popular (even popular analytic) impression real recurrent expenditure stripped of military and debt service peaked in 1978/79 and fell sharply to 1984/85. It has since stabilised in real terms and probably grown 1 to 2½% a year but this means at best per capita stagnation (on 'new' 2.75% population growth rate which probably pertained from 1960 as 1967 and 1977 Censuses were not truly comparable making assumed 3.25% rate wrong for 1977-87 and almost certainly for 1967-77).
4. Thus the problem is not runaway normal expenditure. On the contrary per capita normal recurrent expenditure has been cut dangerously low. The problem is primarily on the revenue side.
5. This is not to deny expenditure problems:
  - a. Defence - controllable and cuttable except when real threat to security, i.e. Amin invasion, danger RSA proxy takeover of Mozambique and/or entry into Tanzania. In such cases not controllable by fiscal means in context of real danger to survival or domestic peace. Withdrawal of Uganda and Mozambique forces was primarily fiscally driven and at earliest moment it

was possible to argue that removal was consistent with safety of friendly state or of Tanzania. Arguably too soon (especially Mozambique) so fiscal leverage on military spending is in world terms astoundingly high and effective (fiscally).

- b. Debt service - only external debt write-off (not just rollforward with deferred interest paid into blocked account) plus a more careful consideration of treatment of interest on pre 1985/86 domestic borrowing (i.e. a case for partial write-off) via - say - 10% interest plus minimum use of non-soft finance (domestic as well as external) can control this and only recurrent balance from own resources (tax plus returns on capital - whether dividends or interest) can create structural safety.
- c. Subsidies to cover operating losses of public and private (e.g. Co-op) enterprises either in the year incurred or later. (A once for all write-off/subsidy is needed - as argued in earlier separate memo - to restructure financial sector. The problem addressed here is continuing losses.) There is progress with one fatal exception. The structural deficits Marketing Development Bureau oversight (i.e. overlooking) built into crop marketing over 1976/77 - 1980/81 have not been controlled. Privatising crop marketing - Co-ops are private enterprises and in Tanzania ones de facto 'owned' by their regional managers who are to all intents and purposes accountable neither to peasants nor the state - has simply shifted loss initially to NBC books but inevitably it will ultimately fall on Budget as NBC will not be allowed to collapse from bad loans state ordered it to make to cover Co-op deficits. This deficit is the primary engine of inflation in Tanzania today (in year when losses are made) and will be (with a lag until Budget pays off NBC) main recurrent budget imbalancer. Unless it is stopped there is no hope of price or recurrent fiscal balance. (Separate earlier memos treat this point.)
6. The apparent 1985/86 - 1989/90 improvement in fiscal recurrent balance is not wholly real or at least not structural:

- a. real tax revenue is rising (as the economy has resumed growth);
  - b. collection has improved (a trend continuation not a shift), which are structural factors;
  - c. but the primary gain is substituting external grants or very soft loans for domestic bank borrowing;
  - d. "c" is necessary and will continue to be necessary for - say - 5 years. It cannot be a structural solution. First, it mortgages all policy to donors and makes a beggar of the Treasury in a way investment borrowing does not. Second, it is not sustainable - 'donor fatigue' will ensure that;
  - e. the co-op losses actively holding up inflation and domestic credit growth while crippling working capital flow to viable enterprises are not now 'on the books' even though they will inevitably go there in the future.
7. Revenue raising must be the main answer to structural recurrent imbalance. It will not be easy:
- a. the 1978/79 - 1984/85 real falls were small absolutely or relative to GDP compared to other severely depressed economies. Tanzania's fiscal collection will and performance was and is very strong for a low income, low growth economy. This may be meritorious, but means all 'easy ways' to raise revenue absolutely and relative to GDP have been used already;
  - b. recurrent revenue is highly manufacturing output (via sales tax) and moderately to highly import (via import duty and, even more, direct and indirect inputs into manufacturing) buoyant. This means its growth depends ultimately on GDP/capita growth, manufacturing growth and exports plus external finance less debt service (which determines imports).



8. That is, the conditions for rapid return to recurrent fiscal balance are:
- a. 6% to 7% annual GDP growth;
  - b. including 6% to 8% annual manufacturing growth;
  - c. made viable by:
    - i. 5 to 8% export growth (in import capacity terms);
    - ii. 8% growth of net external resource inflow (i.e. soft loans, grants, selective less soft loans or equity for hi payoff/hi export projects less debt service).
  - d. continued cautious rebuilding of real recurrent spending (excluding debt service and defence) at 4% a year;
  - e. wiping out the structural deficit on crop marketing - preferably by giving peasants and state power to exact accountability over costs (peasants by power to sack managers, state by telling NBC to say no to all imprudent credit to cover losses and by having data to identify necessary costs and to show how to hold costs to those levels, i.e. to generalise TFA/KNCU practice! - which over 1967/74 it had begun to build up and apply before MDB junked any efforts in that direction and Kilimo/Co-ops in 1984/86 refused to allow its reconstruction).
9. Unfortunately,
- a. # 8 is not primarily a fiscal exercise - it might be easier if it were;
  - b. therefore Presidential Tax Commission can at best contribute a little to tidying up and nothing to solving structural problem;
  - c. just as Commissions on cost cutting have yielded some marginally useful ideas (and some impracticable/undesirable ones) but really

help get more value for expenditure not to cut already dangerously low levels so too Tax Commission cannot solve structural revenue lag which is basically manufacturing and import growth lag caused;

- d. # 8-e has been a known challenge from 1979/80. Warnings were made that 1984/86 privatisation to co-ops would raise costs/deficits unless cost control and accountability were imposed on returning co-op managers whose past tendencies (most not all of them) to profligacy and non-accountability were only too well documented and had indeed led (in response to peasant demand in most regions) to 1976 suppression of CUT and most Unions (not TFA whose relatively well off, educated members did hold its managers responsible and force them to keep costs under control). The warnings were not denied on Treasury/Minister of State (at the time) level. But the inaction of MDB/Kilimo and the action of CUT lobby (and their mobilisation of peasants to support them by misleading the peasants as to why funds to pay them were short) prevented effective action. Real political will and will to explain to peasants, trust them, give them power over managers is vital to success. 1984/90 gives no evidence such will exists outside, perhaps, Hazina. It could be mobilised - the press clearly doubts Co-op Managers claims to be victims and could be mobilised, many peasants have no faith in Unions and want to control primary societies. It could be but will it be?

10. Investment (project, equity, loan) expenditure is a separate issue. In principle there is no problem with covering such expenditure from domestic/foreign borrowing and/or grants. The practical issues are:

- a. being sure it will contribute to raising output so tax revenue growth will cover interest;
- b. on loan money to public enterprises/joint ventures being sure their revenues will be adequate to pay interest and eventually repay loan (unless in special cases it is planned not to recover principal in which case grant finance or recurrent surplus - when achieved - should be used);

- c. having total investment which is neither grossly inflationary by its amount (exclusive of how financed) nor crowding out private. (In practice these two criteria but not "a/b" - especially "b", see earlier memo - have generally been met. Private investment at least until 1988/89 under-used financial system total availabilities, but only because of first stagnation and then hold-over capacity and cash balance slack.);
- d. avoiding mistaken projects both a.) inherently micro unsound (record uneven but by world standards not bad, e.g. UK is worse); b.) projects macro context of economy will render unviable (bad record but projecting 1978 war and 1980s external economic/climatic shocks would have required omniscience. But now crucial to make realistic projections).
- e. Ensuring recurrent costs of capital projects are in recurrent budget projections and do not per se drive recurrent budget into deficit. Contrary to popular (including popular analysis) view, this condition has usually been met in Tanzania. For example, UPE was costed on recurrent side well in advance, most government projects have had estimates of recurrent costs. Failure to meet these costs (especially maintenance) relates not to faulty projections of cost; rather it is primarily the result of real revenue falls and forex shortages.

Thus the Investment Budget and its finance is - if the Recurrent Structural deficit is closed - a manageable, finer tuning not a structural problem.

11. Revenue Fall. Revenue has actually not fallen significantly relative to monetary GDP and the 1977/78 - 1986/87 falls started by (77/78 - 78/79) fiscal laxity and perpetuated by economic decline (see below) were largely clawed back in 1987/90 (excluding grant aid).
12. Real (domestic non-borrowing) revenue in constant TSh terms evidently fell from 1977/78 to a low in 1985/86 from fall in % of GDP and fall in real GDP. Thereafter it recovered. In 1989/90 it was probably at

a record level absolutely though not per capita in constant price TSh terms.

13. Net of defence - debt service - subsidies the fall was much sharper. There are some divergences in timing as well. Worse on this basis any apparent recovery is probably offset by fiscally (not inflationarily) concealed losses of privatised co-op crop marketing. This is perhaps not quite true - the foreign grants that balance the recurrent budget are in fact, even if not overt allocation, the source of external debt service (whether actually externalised or paid by Hazina to blocked Benki Kuu account).

14. # 13 explains an apparent paradox:

- a. falling real recurrent services 1987/88 to 1984/85 and recovery at or below population growth since;
- b. despite record real domestic recurrent revenue; and
- c. a real unit cost of government services rising less rapidly than Retail Price Index (because real salaries are falling).

(One further issue is that RPI has risen so much faster than GDP deflator as to suggest latter may be biased downward. If so then revenue/GDP ratio may be overstated.)

15. Recurrent revenue is buoyant ('progressive') relative to:

- a. GDP/capita growth;
- b. manufacturing sales growth;
- c. import growth.

As in real terms all collapsed over 78/79 - 85/86, higher taxes and tighter collection could only limit the fall.

16. # 15 is true because indirect taxes on sales are structured to be progressive up to say TSh 150,000 household expenditure (or perhaps TSh 300,000. In 1972-74 progressive to \$3,000 - no later assessment

but no change in basic tax and consumption structures). The basic element is that as cash income rises so does the share of total income spent on taxed (basically manufactured) goods. Import growth is crucial to allowing manufactured sales growth (primarily by supplying the average 25% of ex factory pre tax price which is imported inputs and spares; secondarily by facilitating transport; tertiarily by consumer goods imports - other than untaxed raw food) and thus is also highly relevant to revenue buoyancy.

17. This is a sound system. It is progressive; pretty well inflation proof (indeed too much so on income tax!); buoyant (rising % monetary GDP) when real cash consumer incomes are rising. But these virtues mean it performs very badly in revenue terms when real cash consumer incomes fall, domestic manufacturing volume contracts and real imports (excluding raw food) fall.
  
18. The cure cannot be to make it regressive and buoyant when real consumer cash incomes fall. (This may not be feasible; it is certainly not desirable.) Thus the only basic way forward is to restore growth of real consumer cash incomes (per capita), real domestic manufacturing output and real imports. (To do the latter in the short run requires reducing debt service, increasing grant/very soft loan aid and selective use of foreign equity/harder loans for export intensive projects and raising/diversifying exports to cover added imports for added volume and initial higher % import content new industries.

B. Some Tax Points

19. A single rate Sales Tax would in practice be a thoroughly bad thing:
- a. equity loss as would reduce top rates and raise lower; plus
  - b. revenue loss as would not raise lower ones enough.
20. That is for no gain. A 5 rate (say 0% - 25% - 50% - 75% - 100%) system is perfectly administrable (record shows that).
21. Separating "Excise" was folly and should be reversed:
- a. administrative nuisance;
  - b. special ST rates (outside 5 bands) on:
    - i. beer/hard drinks
    - ii. cigarettes/tobacco products
    - iii. petroleum products
    - iv. saloon cars
- are quite manageable because the number of significant producers is low (even treating each plant as a producer which for collection purposes is valid, i.e. 4 breweries on mainland not 1 in this sense) in "i-iii", and "iv" is basically imported, and also because the product groups are clearly differentiable from all other product groups. The IMF intended this shift to be a stalking horse for a single rate ST, the only context in which a separate Excise makes sense (to preserve higher rates).
22. Simplification has virtues - including avoiding time wasted on trying to be sure of category/classification when many different rates:
- a. Not over 5 basic import duty and sales tax classes plus limited number special ST classes (see "21") and limited number protective tariffs;
  - b. Avoiding duplication, e.g. stamp duty on receipts (except for services) duplicates ST and would be more cheaply and effectively collected (i.e. the revenue would be easier and cheaper to get) by marginally higher ST;

- c. Avoiding high collection cost/revenue nuisance taxes especially when easily evaded and/or positively begging for corruption, e.g. road toll, minor (i.e. low charge, millions of collections) health fees (unless community set, collected, used at local health unit level).
23. Income tax does need review to offset inflation. This is now done automatically only at minimum wage level where no tax up to minimum wage level and 1986 on policy of raising MW by about prior year's inflation does de facto index. Ad hoc post 1984 changes have reduced inflation creep impact of raising tax on real income as prices and nominal incomes rose but probably have not done enough. But any such reform has a high initial revenue cost. Can it be afforded now?
24. Otherwise Income Tax (YT) works rather well, is simple, has built-in collection improvement trend:
- a. basic tax free base, no complex allowances;
  - b. separation earnings of husband/wife (vital incentive to educated wives working and parallel to standard household budgets division of husband's and wives's separate income/expenditure flows);
  - c. limited tax credit for wife/children.

Continued emphasis on training and on strengthening assessment/enforcement on big individual and company tax payers is needed but so far this is recognised and has some dynamic of results.

25. But income tax/company tax has a problem. With rapid inflation, depreciation on historic cost does not allow asset replacement if equity has been used nor debt repayment if external loans have been used. A serious evaluation of how to:
- a. avoid bankrupting otherwise viable companies; and
  - b. avoid collapse of revenue flow  
is needed.

26. One interim solution:

- a. allow all assets purchased on foreign loans (retrospective to 1982) to be revalued on basis exchange rate for depreciation purposes until debt service is completed;
- b. in Price Commission/TANESCO type cases use formulas for prices/rates that adjust for import content (at forex price) not just average inflation. (TANESCO has proposed such formulae and should be allowed to act on own initiative on them. Only increases above them should go to Cabinet. 6 monthly 10% to 12% increases will not create crises; it is delay in acting at all leading to late 50% rises that cause real trouble).

(Full current cost pricing depreciation allowances would go too far in principle and cannot be afforded in practice.)

27. Revenue strategy/policy should focus on basics:

1. Sales Tax (especially about 20 items accounting for 90% of tax);
2. Import Duty;
3. Income Tax (including company tax);
4. Road user charge package:
  - a. gasoline/gasoil/motor diesel tax (basic source);
  - b. saloon car sales tax and/or initial and transfer registration charges (consumer amenity tax);
  - c. licenses on heavy vehicles (to offset their special road wear and tear impact).

The present registration fees do little harm but could perhaps be subsumed in "b"/"c" while annual licenses on saloon cars/light vehicles could be subsumed into "a"/"b". No harm as registration/annual licensing is needed for non-fiscal reasons



and present methods are relatively low additional cost to what is needed for non-fiscal purposes.

28. There is one real abortion of a semi-major tax: Poll Tax. Pre-1970 experience shows it is very hard and high cost to collect and impossible to do so equitably (a very rough multiple level charge is least bad possible), humanely (vide "black hole of Mwanza" case), efficiently (average collection looked to be 60% of those taxable in 1960s) at decent collection cost/revenue ratio (seemed to be ca 25% in reasonably well run districts). There is no more reason to suppose it is reformable now than it was last time.

29. An alternative would be:

- a. a basic revenue allocation to each district as of right (as "own revenue"); based on
- b. making - say - 25% of Sales Tax allocated on a population share basis local government revenue collected for them by Hazina.

This is better than present tax on all counts since ST is in fact progressive for 95% of adults.

30. But I cannot advocate moving on "29" until Recurrent Budget approaches balance on own revenue basis and has surplus including grant aid. Then "29" should at once be substituted for local Poll Tax.

31. Local government should concentrate on:

- i. rates;
- ii. Land rents (like "i" they can collect better than Hazina/Ardhi. Perhaps Ardhi should register land and collect premium on initial acquisition/transfer of user right and then notify District of rent District should collect and keep);

iii. certain fees (e.g. stall rents, rubbish collection) which are modestly cost effective, are for real services not all/most citizens use, don't create great equity problems.

(I would advise Primary Health - Primary/Non-Residential Secondary Education - Water charges be negotiated with user community at village/ward level on lump sum basis, collected by community on basis agreeable to it, be used largely or wholly at unit serving community. This suggests lower than District level, albeit District might monitor.)

32. The above could:

- a. reallocate personnel to more tax productive uses;
- b. clean up system to run more smoothly;
- c. raise equity;
- d. eliminate a few anomalies (e.g. bankrupting firms with external loans because they cannot adjust depreciation to cover repayment cost).

All useful, at end of day could collect 5% to 10% more at same cost and with less equity, disincentive problems. But 3 to 6 years to do; certain key items (e.g. "23", "29-30") can't be done before restore recurrent budget basically balanced out of own revenues. So not answer to budget balance in next 2 to 4 years, even though should begin acting now.

C. Basic Goals/Some Strategic Parameters

33. 8% to 10% real revenue growth for at least 5-8 years is needed followed by a 6% to 7½% trend. That means:
- a. 5% - 6½% GDP growth; including
  - b. 6% to 7½% manufacturing growth; and
  - c. import growth needed for "a", "b".
34. The answers to Para 33 are clearly not (or only marginally) fiscal policy ones. Transport and manufacturing rehabilitation and mobilising import finance (exports, foreign inflows, reduced debt service outflows) to sustain rehabilitation and raise capacity utilisation are the strategic issues on 2 to 5 year perspective.
35. But "33"/"34" work only if Recurrent Expenditure can continue to be controlled while restoring at least 4% real annual growth in non-defence/debt service/enterprise loss cover component.
36. In fact the problem centres on cutting (or holding under 4% real growth) the defence/debt service/enterprise loss cover triad. The other areas can be held to 4% - they were cut in past so keeping rise to 4% real is well within Budgetary System's technical and political capacity.
37. Defence can probably be scaled down now:
- a. equipment purchases below wastage;
  - b. less fuel/ammunition/etc;
  - c. cut recruitment radically to reduce numbers by attrition.

This assumes present slow improvement in security in Mozambique continues or accelerates and RSA continues run-down of regional assault. Under those conditions Hazina can achieve - say - 2½% to 5% a year real cuts in Defence (and perhaps more);

38. Debt service:

- a. external - push for write-offs (all or part) exporter government guaranteed credits (and accrued arrears thereon);
- b. external - ensure all past Bank rate IBRD loans really have been converted to IDA credits;
- c. external get all IMF drawings converted to ESAF;
- d. domestic - control inflation to allow lower future interest rates;
- e. domestic - consider 10% ceiling on pre-1984 advances/stocks/etc., including rolled over (literally or in practice) items at least in respect to BOT/NBC/TIB-TRDB/NIC/NPF/POSB.

This could hold real debt service growth well below 4% and if "a"-  
"b"- "c" worked well could reduce real debt service for several years.

39. Enterprise losses:

- a. see earlier memos;
- b. see Paras "5-c", "6-e", "9-d" above on Co-op losses (i.e. private sector enterprise losses falling on public sector);
- c. the real challenge is "b" - other cases after initial financial sector reconstruction one off cost do look controllable (in past no pre-MDB pattern of heavy enterprise loss subsidies and the MDB allowed loss pattern concentrated in crop marketing). Give the peasants power over managers, primary societies over unions; NBC/TRDB/Co-Bank over whether or not to lend; Government to intervene if necessary (hopeless or fraudulent management); build up data base for cost calculation/control. The problem is breaking Kilimo/MDB/Co-op Manager blockade of change which serves nobody's interest but the Managers' and is main present engine of inflation and potential barrier to rebalancing Recurrent Budget

as well as cause of too tight bank credit for viable enterprise expansion (the Co-ops/Boards use it up to cover losses - and to a much lesser extent stocks of crops delayed by transport bottlenecks).

40. Savings other than those at Para 39 will be hard to come by and slow. Further they will be easier in a context of overall real Recurrent Budget Growth.
41. Certainly there are surplus government employees but the categories show only 1 on which it is easy to move:
- a. "ghost" workers (paid but do not exist) - probably mostly "exorcised" but by all means have another go;
  - b. education/health/water personnel with too little to do until more books, drugs spares, equipment, fuel, transport, etc. Very inefficient to fire as they are trained cadres who will be needed again;
  - c. the 40-60,000 persons who are (however now titled) Kilimo, Region, District, Board ex-bwana shambas or equivalent. They never did much good and are in fact below average peasant farmers (haven't farmed for so long) with little training and low use in other jobs. Politically firing is probably impossible. But even at cost of 2 years pay gratuity (paid in two fiscal years) getting 30,000 off payroll and back on land (only option open to most) would be desirable. (No cost saving until Year 3.);
  - d. Too many messengers, cleaners, etc. OK - but as many are 20 years in service don't rehire, i.e. cut establishment but "grandfather clause" present holders. Can get - say - 2,000 to 3,000 a year for 5 years as they retire. (Small, slow gains.);
  - e. Incompetent or grossly lazy 10% (at a guess). No civil service can handle 10% "for cause" type retrenchment. Victimisation and mistakes are certain.

42. One general slow, partial 'cure' might be:
- a. Cut all establishments below para-professional grades 10% grandfather clausuring incumbents so fall comes as they retire;
  - b. On all posts except teachers, medical personnel, accountants, engineers, impose a rule that - without special Treasury consent - new hirings must be below retirements/leavings, etc. and not over 1% of staff now in place. (Maybe 2½% to 3% out, 1% in plus ½% proved special cases over maybe 100,000 people so 1,000 to 1,500 a year saving for 10 years.)

These measures might lower government (including regional and local government to whom they should apply) employment 3,000 to 4,500 a year for 5 years. As mostly at bottom end of pay scale this is a quarter of a % savings on non-defence/debt service in Year 2 and say 1.0% in Year 6.\*

\* (1.0% saving in numbers time 45% payroll to these categories of recurrent spending times 50% of average government wage = .012 x .45 x .5 = ¼%)

43. General waste beyond type better accounting, inventory control, procurement reduce (and these are on agenda already) is low. Keep trying but move to avert increases than to get real net savings. Major gains here impossible. Better accounting, inventory, procurement procedures and control by Year 6 might save 1.5%.

D. Fees

44. In general this is another false hope with clear "no through road" sign. The basic fiscal reasons are clear:
- a. any charge under Sh250 is cost inefficient to collect separately - at least by Hazina's own personnel;
  - b. in addition it diverts scarce personnel from general professional (nurses, teachers) or fiscal (tax officers) work of higher real value. Very high opportunity cost.
  - c. decentralised collection for Hazina is impossible to police at acceptable cost especially if waivers (say 25% of cases) are allowed to avoid excluding very poor people.
45. There is no way to overcome "a" and "b". "c" can be overcome by requiring 95% collection (based on pupils enrolled, drugs issued, etc.) and prosecuting under Gross Negligence Act when not achieved. The disadvantages are clear:
- a. denial of access for very poor people - probably 20 to 25% of population;
  - b. huge waste of decentralised professional time used to collect 'hard cases';
  - c. destruction of decent relationships between teachers - nurses - medical aids and people they serve;
  - d. clogging courts with a host of prosecutions resulting from an unsound fiscal approach.
46. If community contributions are to be raised there is a simple standard format:
- a. negotiate annual lump sum for community with relevant body, e.g. Village or Ward Council, Water Users Committee;

- b. accept payment in kind to the unit, e.g. labour time (construction/maintenance), materials and furniture (ditto), food for staff and/or patients/pupils;
  - c. let community set basis of charge (probably annual flat or quasi-progressive differentiated charge per household per year) and be concerned only that payment is made;
  - d. concentrate community resources on local unit so the payers see value for money.
47. The above is simple. It can work. But it is complex to administer on state side and requires total rethinking of how government units relate to participating communities. Over time it could provide substantial additional resources and better/more accountable services but it is no fiscal panacea and will take time to build up.
48. Per use drug fees are the exact opposite of this model:
- a. collected in small amounts and large numbers;
  - b. cash only (and at precise time household has more other costs and less income because of illness);
  - c. not in any way responsive to context or to community participating in true sense as opposed to be unpaid tax collection agent;
  - d. by their nature paid to the centre with probable "out of stocks" and lags making relationship of drug supplies and fees quite invisible at primary care unit level.
49. Yes, amenity fees/charges (e.g. more space/better food in hospital, i.e. "hotel bill") are justified and can probably be collected semi-efficiently by the unit (especially if yield goes to its budget). Yes, in cases like university education which, a.) cannot be for all and b.) give real material gains to recipient a cost claw back is



sound ethical. But as added income in this (university) case is well after cost and is uncertain, the only plausible way is loans recovered by a surcharge on income tax related to how much income (and thus income gain) is. Fiscal gains low, none too easy to collect (records problems) and slow. Worth a go perhaps, but talking of post-1995 gains of a fairly small % of university costs.

### E. Conclusion

50. There is a fiscal problem. Basically it is too low revenue leading to too low (non-defence/debt service/enterprise loss subsidy) recurrent spending.
51. The basic cause of the revenue problem is low growth and in particular low growth in sales of manufactured goods. That is not a fiscal problem in itself even though it causes the fiscal problem.
52. Tax reform gains can at best be marginal.
53. With three exceptions the same holds on expenditure efficiency raising.
54. These three exceptions are:
- a. non-privatised (via Co-ops) crop marketing loss falling ultimately on Treasury;
  - b. defence which can be cut as Southern Africa context improves;
  - c. debt service where external write-offs and a two tier policy on domestic debt interest could lead to significant savings.
55. While "52-53" potential gains are not to be ignored (and are discussed above) they will be marginal not structural.
56. The "54-a" gain must be achieved because without it inflation and credit squeeze cannot be reduced as well as for fiscal reasons. The "54-b-c" ones need to be pushed.
57. Community (not individual/state direct) participation in service provision and finance could augment resources and accountability. It is highly desirable. But it will take at least 5 years to build up and its fiscal gains are likely to be small.

58. But the central strategic elements are:

- a. rehabilitating transport;
- b. rehabilitating manufacturing;
- c. raising capacity utilisation in both;
- d. mobilising the forex (exports, external inflows, debt service cuts) to do so.

RHG  
Sometime EA/T  
Seoul-Hague-Falmer  
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## BANK CREDIT: ALLOCATION AND AUTHORISATION

By R. H. Green

### Credit Allocation - Levels and Processes

1. Bank credit ceilings are a standard intervention in markets - so standard practicing neo-liberals rarely challenge them! They are real resource allocative and price management tools.
2. The real debates are on:
  - a. degree of articulation of ceilings
  - b. use of interest rates and/or other means of staying within the ceilings.

(Note: In Tanzania today ceiling is - in nominal terms - the operative term because the primary goal is to avoid resource over-allocation accelerating inflation. But in real terms arguably the goal is a floor, i.e. a rate of increase of real working capital advances consonant with a real growth rate of - say - 6% plus creeping increase in monetisation. In general the logical formulation is neither floor nor ceiling but ranges (nominal and real) to avoid excess (nominal) credit fuelling inflation and inadequate (real) working capital blocking otherwise achievable output.)

### Articulation

3. Once an overall bank credit ceiling (usually for commercial and central banking operations only, i.e. excluding medium and long term lending for fixed capital, e.g. TIB, TRDB, THB, TDFL, Diamond Jubilee/IPC, etc. Note TRDB does lend short so the commercial/central bank convention does not in that case correspond to the somewhat more economic reality based one of circulating versus

fixed capital finance) is set the question arises whether it should be articulated into sub-ceilings by:

- a. economic sector
  - b. large borrower
  - c. nature of owner of borrowing unit (including households, co-ops, small businesses, foreign owned enterprises)
  - d. Geographic zone.
4. If the answer to a-b-c-d, is no, then presumably interest rates, commercial bank reserve ratios and/or open market (Central Bank sales of government or CB paper to commercial banks or purchases from them) are the only significant overt tools to be used to square performance with targets. In practice, moral suasion by CB and deliberate rationing of loans by commercial banks are likely to be used. The results of this package of instruments varies and - if interest rate elasticity of credit demand is low - the likelihood of major overshoots (or undershoots) is high.
5. In practice one allocation below macro level is normally made (and is an IMF/Bank demand) Central Government borrowing. It is a matter of taste whether this is seen as a sectoral or an individual major borrower articulation (sub-ceiling).
6. In practice there is a broad agreement on two (or three) targets:
- a. Total Bank Credit
  - b. Central Government Sub-ceiling
  - c. Other Government Sub-ceiling

("c" may be minor in Tanzania but local governments logically should have - limited - overdraft facilities growing parallel to their expenditure or the inflation rate whichever is less. Zanzibar - in practice a financially autonomous regional government should have a separate ceiling - with the BOT - and not an unlimited one subject to

Treasury Guarantee. For instance, the BOT should negotiate annual borrowing ceiling with Zanzibar and stick to it but should not have a Treasury guarantee. Arguably this would get Zanzibar excluded from bank lending to Government IMF ceiling.)

The case for sectoral allocation is an economic management one:

- a. leading sectors should be favoured;
- b. very high nominal interest rates in practice create an undesirable bias toward trade and (less uniformly) real estate and against manufacturing, mining and agriculture;
- c. they also create a bias against activities (sectors) with very sharply fluctuating earnings because interest on losses quickly digs a pit from which no escape is possible.

This debate is neither capitalist/socialist nor conservative/liberal. Japan, South Korea and France have all practised detailed (in fact borrower as well as sector) interventionism to achieve high growth overall and (especially in South Korea case) in exports. Each is both capitalist and conservative. Federal German Banks (in this case on their own initiative and because rapid enterprise growth helped the banks both as shareholders and as beneficiaries of general economic boom) have also managed lending at enterprise (and de facto sectoral) levels.

The interest rate case has figured less overtly in reasons for articulated allocations but has frequently been at least subliminally prominent (e.g. Brazil).

Tanzania on all three grounds should set sectoral ceilings:

- A. Central Government
- B. Other Government
  - i. Zanzibar
  - ii. Local Government

- C. Agriculture
  - i. Marketing - Domestic
  - ii. Marketing - Export
  - iii. Processing
  - iv. Production
- D. Mining
- E. Construction
- F. Manufacturing
- G. Domestic Trade
- H. Import Trade
- I. Export Trade
- J. Transport
- K. Other Services
- L. Consumer
- M. Non-traditional Exports <sup>1</sup>
- N. Unallocated <sup>2</sup>

Note 1 - This would be a 'reserve' to be allocated to enterprises demonstrating that actual orders and production or buying potential could not be met/used on basic allocation. In practice these opportunities cannot be projected in detail a year ahead so will not be included in full in basic enterprise ceilings whether set by Hazina-BOT or NBC.

Note 2 - This is analogous to "contingency" lines in Government Budget. Not all needs can be foreseen. Leeway to allocate to meet opportunities or avoid problems is needed. But it is consistent with macro balance only if a (say 10%) contingency/unallocated line is provided.

- 11. If the sectoral ceilings are to have a real (physical) economy basis they need to be built up from:
  - a. projections of need by main users
  - b. vetted by NBC

- c. plus rough projection by NBC of total needs of other (smaller) users in same sector - within a preliminary BOT/Hazina set of macro and sectoral targets analogous to those given to Ministries at the start of the annual Recurrent Budget process
  - d. vetted by Hazina/BOT in consultation with NBC to set actual sectoral ceiling.
12. 100 largest borrowers account for bulk of credit (probably over 90%). It is prudent (and given method of computing sectoral allocations also relatively easy) to give them enterprise ceilings.
13. Interest rate management either at macro or enterprise or sectoral level won't work well as main instrument.
- a. Interest rate elasticity of demand for credit is low - probably lowest for inefficient, loss making firms!
  - b. Sectoral elasticities vary in a way unrelated to contribution to GDP (probably lowest for import sub-sector of commerce).
  - c. Even were "a", "b" less serious objections, very high interest rates (nominal) build in inflation and deter investment/production.
  - d. The efficiency gain from high cost credit is largely attainable at 2% real or 20 to 25% nominal interest rates whichever is lower. (Hyperinflation or endemic 50% plus annual inflation contexts may be different but these do not pertain in Tanzania.) If that rate is negative in real terms the cure is to squeeze inflation (including by credit ceilings) not to raise interest
  - e. In any event degree and speed of response to interest rate changes is very uncertain (not only in Tanzania) so that in a context of IMF trigger clause M ceilings to rely on interest rates alone is suicidal.



## Allocation and Loan Authorisation

14. Sectoral and key borrower allocation by BOT/Hazina does reduce NBC power of authorisation (albeit if these are ceilings it can lend less if it thinks prudent and to extent it does that in several cases has some leeway on overall levels for smaller borrowers or to ask permission to vire). But the reason is that overall economic policy (which is not NBC's business) requires both overall credit ceiling and attention to allocations to key sectors and users. It is not bureaucratic case by case interference for its own sake.
15. On enterprises, NBC should be chief source of data and advice. Subject to total sectoral ceiling that advice has (at Credit Plan level) rarely been over-ridden.
16. NBC would in practice (for own prudent banking reasons as well as M targets) need to set ceilings for all borrowers and should do so:
  - a. largest 100 on basis BOT/Hazina revision of NBC advised ceiling;
  - b. all others on basis prudent banking practice subject to sectoral credit ceilings.
17. These ceilings do not affect power to decentralise NBC lending decisions much more than is now done. In principle they do not prevent having multiple commercial banks, albeit in practice (vide the Cobank/NBC lending war disaster) credit control and competing banks are very uneasy bedfellows. (To be brutal the risk of financial AIDS from them is at least 50%. Tanzania financial institutions have quite enough problems without looking for new catastrophic risks to assume.)
18. Decentralisation Model - Ceilings
  - A. Hundred largest from NBC-BOT-Hazina dialogue;
  - B. All others over TSh 50,000,000 - NBC Head Office;

- C. TSh 5,000,000 - 49,999,000 - NBC Zonal Office;
- D. TSh 1,000,000 - 4,999,999 any branch whose deposits exceed TSh 100,000,000;
- E. TSh 1 - 999,999 - any branch.

Note - ceiling should be on advice of branch with which enterprise deals primarily in each case with zonal - HQ - BOT/Hazina reviewing. Clearly a big borrower should deal with a big branch for normal convenience reasons and A/B will deal with a handful of Dar, Tanga, Arusha, Moshi, Mwanza, Mbeya branches already. (Annual inflation indexing of ceilings is needed to avoid steadily falling real limits!)

- 19. Avoiding overlending requires -
  - a. borrower borrows at only one branch; or
  - b. borrower has ceiling allocated to several branches as sub-ceilings; or
  - c. borrower goes to different branch (e.g. a Coffee Marketing Co. regional manager goes to Bukoba Branch whereas ceiling set by and at a Moshi Branch) which checks with main lender branch as to whether there is room in ceiling and then (within its credit limit) decides whether prudent to lend.
- 20. These procedures should:
  - a. increase flexibility;
  - b. use branch staffs more fully;
  - c. clear zonal and HQ desks of minor transactions allowing time for proper evaluation of major ones;
  - d. speed up approval (or rejection) of borrowing proposals.

They do require prompt intra-NBC communication in case "19-C". (But this should be rare. If CMC will need overdraft in Bukoba often it should have its ceiling split with a portion at Bukoba.)

21. A client should be free to shift his business to a different branch (allowing competition by service). The only requirement is that the borrower has a single branch advising on, knowing and controlling overall ceiling (including borrowing at other branches by ceiling sub-allocation or special request).  
Note - This is basically what a British clearing bank does with a large client. It has one basic branch and one overall overdraft ceiling with sub-limits at other often used branches and possibility of drawing at any branch subject to its checking with controlling branch (or HQ for a very large customer whose limit is a HQ decision)
22. There may, for large firms with significant international business, be a need for Foreign Branch of NBC not only to have a sub-ceiling within overall ceiling but also to be involved in advising on/setting ceiling. This will be especially true of overdrafts to finance external receivables (incoming payments in pipeline) or inventories (for sale or manufacture) and perhaps inventories (inputs, goods in process, final product) relating to export products. Where these elements are dominant, possibly the Foreign Branch should normally be that customers main branch.
23. With more than one bank communication and coordination problems will increase. The requirements for melding multiple banks and credit allocation are:
  - a. single ceiling for enterprise jointly agreed/advised by NBC/X (other bank) and sub-allocated by branch as well as bank;
  - b. cross checking of overall deposit and overdraft position among all branches of both banks before substantial alteration of overdraft level within ceiling (one supposes ceiling is one thing and level permitted any one time quite another - especially for seasonal enterprises).

24. In practice 23 a/b would be very tedious and likely to be very slow. (NBC is slow now - two banks would be much slower and if speed-up is to be achieved by modernising and replacing NBC's data processing capacity the question arises whether forex for two such systems and - perhaps even more - skilled, experienced personnel to run two systems can be secured promptly.)
25. A two bank system requires enterprise ceilings going down to lower levels than a one bank one to ensure no recurrence of NBC/Cobank credit extension competition of early 1970s. Purely sectoral ceilings would not be enough and 'competition' would result in fudging categories. (NB an enterprise needs to have one overall ceiling but in some cases this may be out of two or more sectoral allocations.) Also there is a real problem in dividing sectoral allocations - how does one decide what share of total lending by one bank or the difference (if any) in the sectoral makeup of each bank's business will be? If BOT/Hazina decide, that in effect ends competition right there (unless every enterprise deals with only one bank and can move complete with Hazina/BOT set ceiling which is very messy and cumbersome). The price of more than one bank would be loss of credit control, grave delay in getting credit approved/disbursed or/and much more intrusive - detailed - rigid central allocation. These risks are not worth taking nor these costs worth paying at least until financial system rehabilitation and transformation is much further advanced and the balance sheets cleaned/efficiency of operations improved.

#### Loosening Centralisation

26. The proposals above would decentralise small customer ceilings to branches, middle size ones to zones and large ones to the HQ of NBC. Even on very large enterprises the proposed ceiling would come from NBC and would only be altered by BOT/Hazina for strategic/macro-economic reasons. (This assumes NBC is given target credit ceiling overall and by sector within which to frame its proposals - analogous to Recurrent Budget process.) Only macro and

sectoral ceiling analysis and proposals would initiate with BOT/Hazina (who are the macro economic managers).

27. Once the system has operated for two years, further decentralisation can be envisaged:
- a. particular enterprise ceilings to go to BOT/Hazina only if the enterprise used more than 1% of total NBC credit (including NBC credit to government) which would probably reduce the number to 20 to 25;
  - b. raising limits of branches and zones within NBC.

Note - where limits are set in TSh then there should be an automatic formula to adjust up each January 1 by the COL increase of previous July-July period (latest likely to be available) to avoid real erosion by inflation. Reviews every 2 or 3 years could then smooth out secondary problems and real increase decentralisation because the approximate indexation of limits prevented real erosion.

#### Complementarity Use of Interest Rates

28. Interest rates do affect borrower decisions. They may do so in ways increasing real medium term efficiency (e.g. tighter receivables and stock control) or the reverse (risk avoidance by reducing turnover and raising prices). Interest rates are inflationary (a 5% rise in NBC's average rates is likely to push up COL by 3% to 4% counting higher producer (manufacturer) prices plus higher trader markups on higher manufacturer base price). High interest rates do focus attention on short run. That is useful to extent it concentrates efforts on rehabilitation and capacity utilisation but harmful if it deters needed buildup of capacity growth and deters entering lines with high but lagged real returns. High interest rates deter taking risk because a first year loss snowballs into an avalanche of red ink even if later years have large pre-interest profits. Thus the efficiency effects of very high interest rates (nominal) are not unambiguous. For what global empirical data are worth (country time series) real rates of -3% to +3% and nominal of +6% to +18% seem to

be the range historically conducive to sustained growth and investment. (Implicitly this suggests a 3% to 15% target inflation band albeit I'd advise 3% to 9%.)

29. Tanzania at present is just out of that range. NBC interest rates are approaching an average of 23 to 25% nominal/-2 to 0% real. This suggests the 1990-1995 priority is:

- a. to push inflation down to 10 to 15% and
- b. interest rates to 12.5 to 17.5% (i.e. 2.5% real).

Once "a" begins "b" will help reinforce the trend by lowering costs. Also once "a" is working devaluation on the formula of:

$$(\text{Tanzania Inflation less Global Inflation}) + 2 \text{ to } 4\% \text{ real devaluation)}$$

would yield lower devaluation thus reducing cost push inflation.

e.g. 25% Inflation  
 $(25\% - 5\%) + 3\% = 23\% \text{ devaluation (nominal)}$

10% Inflation  
 $(10\% - 5\%) + 3\% = 8\% \text{ devaluation}$

30. The key means to getting an inflation breakthrough is a sharp increase in manufactured goods availability and the keys to sustaining that are increased domestic manufacturing and construction output and capacity. By increasing capacity utilisation, thus lowering real fixed costs per unit, increased manufacturing output is inflation reducing on cost as well as supply/demand balance side.
31. The above (Para 30) process turns primarily on a.) forex availability and b.) rehabilitation of manufacturing and of transport capacity. It is not primarily a credit phenomenon and certainly not one lower nominal interest rates now would help.
32. But unless credit for spares, raw materials, intermediates, finished products, receivables in manufacturing (and to a lesser extent domestic commerce) grows in real terms, the output increase/inflation reduction strategy will be blocked. Too low credit ceilings on

manufacturing can be inflationary as to price and recessionary as to output ("slumpflationary!).

33. The key bottleneck in Para 32 terms is credit for Import Support Facility goods sold to the enterprise sector. The users cannot in many cases pay cash on delivery without expanding bank credit which runs into IMF trigger clause snags. Here the practical solution given IMF trigger clauses and their rigidity is:
- a. to allow 30 to 90 day credit from government to enterprise at 2% per month interest;
  - b. to have NBC administer these loans for Hazina taking into account need in setting 30 or 60 or 90 days (i.e. a firm well within overdraft ceiling should borrow from NBC and pay Hazina at once);
  - c. collect the funds when due by debiting enterprise account and crediting Hazina.
34. The above should:
- a. ensure collection on due date;
  - b. allow combined use of these credits and overdraft to be monitored by the commercial credit experts (NBC not Hazina!);
  - c. avoid letting IMF credit ceilings be coffin lids on expansion when increased real resources allow higher output if facilitatory credit is available;
  - d. the 2% monthly interest would avoid enterprises' seeking to shift from NBC overdraft to Hazina loan to avoid interest;
  - e. net lending (loans made less loans repaid) would be an offset against gross borrowing in government accounts whereas simply informally accepting delayed payment results in the sum being treated as "Recurrent Budget Deficit".

35. These must be Hazina loans with NBC as agent - to keep out of bank lending totals! For convenience they should probably be handled by a small team of specialist officers at Foreign Branch who would liaise with Branch (or HQ) and NBC officer basically responsible for the enterprise.

### Interest Rates and Sectors

36. Differential interest rates by sector are primarily a concern in respect to fixed rather than circulating capital borrowing. That falls outside NBC interest rate concerns. (For example, it is not sane to use overdraft as basic source of finance for residential housing so THB not NBC has housing finance rate headache).
37. But there is a special sectoral problem in respect to circulating capital loans for agriculture. The problem is that output is unpredictable by year even when estimatable on average for several years. 25% interest means that if the first year is the bad one recovery may be impossible even if subsequent years are good and if in 5 years 3 are good, 2 bad and the whole slightly above projection the enterprise is likely to be bankrupted if the 2 bad years are #1 and #2. (At 5% or even 10% interest this impact is much less true.)
38. Note - this applies primarily to working (input) capital for agricultural producers not processors nor marketers because in a bad year the producer has expenses but no revenue whereas processor or marketer (while hit by low turnover and thus problems in covering fixed costs) at least does not buy the crops/stock that haven't been produced. The problem is real but the solution (at any rate in practicable terms) is far from evident. The best attainable model might be:
- a. agricultural producer interest rate 2% above normal rate; but
  - b. in case of bad crop (say 25% below reasonable projection - agreed at time of loan?) interest would be cut to 10% and 50% (or 100%) of principal would be rolled forward;



- c. in case of disaster (50% shortfall) interest would be waived and principal rescheduled to be paid 1/4 - 1/4 - 1/4 over next four years with interest on rescheduled amount at 10% (or half basic rate whichever is less).
39. The 2% is de facto an insurance premium. (It is in fact rather too low so there would be a subsidy on proposals at "38 - b, c".) However, there is a practical problem more serious than the exact insurance premium/acceptable subsidy one:
- a. perhaps output targets and outturns could be agreed/determined for enterprises, e.g. sugar companies;
  - b. but for co-ops or peasant farmers the data would have to be by district or ward and based on Agric Officer estimates. These are of dubious accuracy for credit terms reduction use and the officer would be subject to local pressure to 'declare' shortfalls even when they arguably did not exist.
40. But the principles of insurance are sound and Para 38 could be a way forward. Thus TRDB (jointly with NBC) should hire IFM or IFM/Sokoine University to do a study on possible, functional insurance premium/bad year interest reduction - principal rescheduling schemes for agricultural producer (enterprise and peasant) circulating capital credit.
41. Small enterprises are not an economic sector in the sense that agriculture or manufacturing is. Their claim to lower interest rates is more social populist than economic. They do have limited capital and they do face risks on establishment or expansion. NBC credit isn't intended to substitute for equity bases nor is high risk of bankruptcy (and real as well as financial asset loss!) a very compelling reason for low interest rates. To be of much use these would need to be 50% lower. As both risks and costs are higher for such loans, NBC would in practice study each so carefully that:
- a. cost per TSh 1.0 million loan would sky-rocket.

b. NBC by delay and refusal would lend less to small enterprises.

Those results are inefficient, perhaps especially "b" as alternative credit it present costs more (10% a month in the bazaar so it is said).

42. What could be done?

a. encourage existing Savings and Credit Societies (BOT to do or commission IFM to do study on present situation, trends, possible expansion);

b. investigate potential of tontines (a somewhat grander, more enterprise oriented variant of "a") - IFM to be commissioned to get data (e.g. from World Bank, ADB) on Cameroon variant, examine whether there is a Tanzanian one and propose what might usefully be done by legalisation, technical assistance, data collection (not regulation under Banking ordinance).

43. Because these bodies are composed of members who save and borrow and are fairly small they can assess credit risks faster and better than NBC and use social channels and pressures against defaulter better too. Their interest rates are likely to be at or above NBC levels but not 10% a month. (The saver members could - with safety - get at most 12 to 15% on term deposits in formal sector so a 25 to 30% lending rate by tontine so long as risk is controlled is attractive to them.)

44. If this could be done NBC could:

a. lend to small business on normal rates:

b. but insist

i. fixed capital should be all equity (owners' funds) or equity plus savings and credit plus tontine sourced;

- ii. one third of circulating capital also financed in that way.

Which would increase demand for S and C plus tontine funding and reduce NBC risk.

45. For this purpose Co-ops (other than Unions and large primary societies) are analogous to other small enterprises. They have the advantage that co-op members could organise own S and C society to serve themselves and their co-op. To date the co-op record is so uneven and the data base so poor that subsidies via interest rates to co-ops as a group (whoever paid the subsidy) are unwise. Specific initial capital grants by NGO's or local government to specific co-ops (especially ones which are able to build economic opportunities for women) are a much more promising route than blind NBC sectoral preferential interest rates. Usually they also should include technical assistance/training or financial recording and mangement. (Funding Co-op College and IFM courses and 'extension' officers in co-op accounting and finance at basic levels would be worth doing. The courses should be free or low cost to co-op. If TRDB, Co-Bank, NBC want to aid co-ops, grants for such courses would probably be more efficient than untargeted interest rate subsidies!).

#### A Warning Note

46. Contrary to popular belief bank credit creation (even including currency in circulation in money supply and demand/use equations) is not a fine turning device either for output growth or inflation.
47. The reason is simple even if readily obscured. It turns on the quantity equation in stylized form versus in reality.

This is

$$MV = PT$$

M = Money Supply (Bank Credit + Currency)

V = Velocity (how many times M turns over/is used in a year)

P = Price Level

T = Real Volume of Transactions.

48. To calculate ex post for a past period is relatively easy albeit not precise:

M is known.

P is logically knowable albeit neither COL nor (especially as now guesstimated) the GDP deflator is a good proxy.

T can be estimated from GDP growth and a guess at growth of monetarisation/intermediation which raise M consistent with any level of P

V is then a residual.

49. Projection is usually done by setting:

T at some real increase in GDP

P at maximum allowable price increase

V as a constant

M as residual

e.g.  $T = 1.05$  (5% growth)  
 $P = 1.10$  (10% increase)  
 $PT = 1.155$   
 $V = 1.0$  (no change)  
 $M = 1.155$  (15.5% growth)

50. Unfortunately V is not a constant nor is degree of monetisation nor is achievable real output change very accurately predictable. Thus an M growth of 15.5% in above e.g. might or might not be consistent with 10% price increase

e.g.  $M \quad V = P \quad T$   
 $(1.155) (1.1) = (124.5) (1.02)$

Here V rose and output growth was blocked by weather or import constraint. A 24.5% price increase results even if M ceiling is held.

51. Further P is influenced by non-M factors, e.g. wages, exchange rates, profit levels, electricity-water-fuel bills, domestic input costs, taxes. If these produce a floor inflation of 15% and V happens to be constant:

$$\begin{array}{ccccccc} M & V & = & P & T & & \\ (1.155) & (1.0) & = & (1.25) & (92.4) & & \end{array}$$

that is while prices are above the target this has nothing to do with excess M. On the contrary too low M has turned practicable 5% rise in GDP into a 7.6% fall.

52. This is not to say M ceilings are useless but that:
- a. P in absence of M effect should be calculated (estimated)
  - b. T should also be projected (including - say - 2% monetarisation factor plus 6% growth in real output if attainable given import constraints and other - e.g. transport - bottlenecks)
  - c. V should be held constant at that stage but in full knowledge this is unlikely actual
  - d. then PT may be 1.25 (1.08) = 1.35 and with V = 1.0, M needed is 1.35 (35% growth). (With 6% real growth calculated P rise might be too high because there would be less 'absolute scarcity markets' and T might fall with lower inflation encouraging people to hold on to money in current deposits or notes longer. These effects might or might not cross-cancel).
  - e. the ceilings on M and projections of T, P and V should be projected by quarter and reviewed by quarter. If T change seems to be different from projections then M should be adjusted (up or down) and similarly if P (using a weighted average proxy using 50% exchange rate, 30% average wages, 10% Tanesco tariff, 10% domestic crop prices because these should roughly capture costs and thus non-M inflation using data which are to hand fairly promptly) is above or below projection M should be adjusted (up or down, e.g. if projected devaluation was at 30% annual rate and

it is in fact at 20% annual rate then non-monetary P rise would be significantly lower requiring lower M growth).

f. even so neither projections nor review corrections are ever going to be precise enough to fine tune.

53. Note the above is a logical approach and one making economic sense. But it is not workable in the context of IMF ceilings for two reasons:

a. in negotiation IMF tends to insist non-monetary P should be O and then ad hoc agree to X%. (However an own estimate of non-monetary P should help get X closer to likely increase in P).

b. IMF ceilings prevent M above ceiling revisions (albeit not the reverse) unless one is sure the IMF will promptly grant a waiver or no IMF funds are to be drawn and other funding bodies will in fact tolerate a hiatus in IMF agreement "compliance" while IMF decides to concur or to negotiate a new agreement.

c. as IMF often sets M's that would force T below otherwise attainable real level some gambling (or calculated risk taking on "b" is necessary). It will be safer once NBC books and total live credit outstanding are cleaned up as proposed in other memos.

54. None of above invalidates statement that excessive M - especially to cover structural government or crop marketing deficits - will raise P. Thus it does not mean credit ceilings are useless, only that they must be calculated/projected/revised seriously, not by mechanical use of  $MV = PT$  with little or no regard for either institutional financial, transaction patterns or physical economy realities. The IMF - especially in SSA - is notorious for not getting these realities factored in adequately (or with some peculiarly obtuse missions refusing to accept that they can be significant!) and for being institutionally unable to review promptly on a quarterly basis despite its formal stance for flexibility and speed of response to the unforeseen or the previously unknown.

A Reassuring Note

55. Basically this Memo takes a hard - pro (nominal) credit ceiling line. But also a hard pro (real) credit floor line. Money supply generated inflation and deflation are inefficient and so is lax allocation of credit to individual users.
56. This is not the same as being hard hearted toward vulnerable and/or poor people:
- a. inflation hurts them - they cannot adjust their incomes up to meet it as well as the less poor and their belts have less room for tightening;
  - b. the crop marketing deficit hurts them via inflation but - except by accident if some crop prices are unsustainably high - benefits less poor employees of and service providers to the marketing bodies. Waste is, as Mwalimu has repeatedly said, a sin especially in a low production level poor country concerned about the welfare of poor people. (Government deficits are more ambiguous because basic services do benefit poor people and might be where cuts fell).
  - c. bank credit ceilings for government do not uniquely determine either revenue or expenditure levels. Over 1986-90 real recurrent expenditure rose (even excluding debt service). So did domestic recurrent revenue. But the near elimination of government bank borrowing has come from raising more external grants (a result tighter M ceilings and real attempts to enforce them - especially vis a vis Central Government - helped achieve);
  - d. sane M management avoids such low M growth relative to non-monetary Price growth as to crush out attainable real output growth (T). Loss of real output growth is usually very bad for poor people even if it is not their own output;
  - e. wage, employment, grower price, investment, basic service access and tax incidence (who pays, e.g. beer tax hits poor less than

sembe tax would) have more effect on allocation of purchasing power than M management and are to a large part independent of credit ceilings, i.e. 1986-89 on policy of holding real minimum wage constant by annual adjustments more or less equal to previous year's inflation has been taken as a given in setting  $MV = PT$  making M a bit higher. A wage freeze (constant nominal minimum wage) to hold P and M down has not been accepted nor even negotiated about.

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1-II-90



## NBC NON PERFORMING ASSETS: A Possible Strategy

### Survey

1. NBC has up to TSh 100 billion in non-performing assets. These fall into four categories:
  - a. Devaluation losses (covered in separate memo).
  - b. Loan losses (literally overdraft to fund client losses) - Agricultural Marketing.
  - c. Loan losses - other state 'sponsored' credits notably Railways, TANU/CCM enterprise.
  - d. Other (commercial) loan losses - notably T. Fertilizer Co.
  
2. "b-c-d-" are TSh 20-25 billion per NBC's estimates. However, these estimates are very conservative eg. 100% for the Cotton Marketing Company as it does have significant assets and substantial reserves for Coffee Market Company and Arusha/Kili Co-ops are very pessimistic as these are performing accounts, backed by assets, lent to economically viable enterprises.
  
3. "b-c" probably total TSh 17.5-20 billion of the total loss estimate. (ie. over 80%). These are advances NBC made under what it believed to be Government or Party instructions. (Whether in fact this was always the case is unclear. But the BOT and the Treasury were not active in counterordering NBC not to advance until they - ie.BOT/Hazina - send consulted state house/cabinet. Thus neither BOT nor Hazina can plead that NBC 'should have known better'). Thus in these cases (ie. certain crop boards and co-ops plus TANU/CCM enterprise, plus railways and probably a few lesser cases eg. TAFICO, Forest Products Corporation?) there should be a Hazina/BOT solution removing the deadweight of losses not resulting from NBC imprudence nor normal banking risk from NBC.

4. Note - the above exercise should be done in a way reducing Domestic Credit outstanding which provides:
  - a. a clearer picture of real bank credit;
  - b. a serious base for arguing with IMF for higher % (on lower base) annual DCF increase ceilings.
  
5. If economy is to grow 5% a year and 6% for monetarised sector then needed DCF is:
  - a. 100% (base)
  - b. +6% (volume increase)
  - c. +2% (monetarisation)
  - d. +x% (to prevent non-money supply inflation from creating real output loss via real DCF fall). If one assumes 6% growth and continued recurrent budget balance (including grants) and ending Agricultural Marketing losses (the main engine of money side inflation) then 30% DCF ie.  $100+6+2+22$  would seem a reasonable 1990 target and 27.5% (ie.  $100+6+2+19.5$ ) for 1991 assuming inflation 23% 1990 and 20% 1991.
  
6. "d" losses seem to be under TSh 5 billion. NBC does have reserves to cover these. Any use of these to write down should be done in such a way as to reduce credit outstanding figure (ie. loans - advances - overdraft - discounts less reserves against specific impaired loans). NBC incurred these losses by bad judgement or quasi-normal banking risk of bad overall economy performance. They are proper charges to its debt reserves.
  
7. The NBC book clearing exercise is one thing; how one treats debtors is another:
  - a. the claims should not be forgiven until the enterprise is set on a sound basis, sold off or liquidated;
  - b. The portion (not necessarily negligible) collectable should be recovered;
  - c. there should be no compunction about NBC and/or 'Residual Credit Recovery Company' putting in Receivers and Managers.

Crop Boards/Companies

8. Not all Boards/Company's are a fiscal mess. Coffee is not. Cotton and NMC are. Sugar, Tea, Pyrethrum may well be. Cashew and Tobacco may be solvent. The fact that Coffee is solvent and profitable - even if not very liquid because of slow transport and therefore high pipeline of stocks both to be cured and cured-demonstrates the any claim that problems are basically exogenous to the companies is false special pleading. (NMC and Cotton may be special cases but if so incompetence of management in identifying, articulating and quantifying problems is colossal).
9. Further these Boards/Companies which are bankrupt can never claw their way back if they have to pay 25% interest on overdraft which de facto finances past losses. That deadweight by making profitable operation impossible makes it almost impossible to ascertain (on available data) whether they are earning an operating surplus before interest let alone whether that surplus could pay interest on their 'live' (ie. asset backed) overdraft.
10. Knowing where we are is precondition for getting structure of operations and level of efficiency adequate to halt future losses. This is crucial because in some cases management may have achieved that, but results are hidden by interest on past losses but in others that interest is used as a smoke-screen to blur present incompetence/losses/corruption, (eg. corruption and it's cognates/agnates have been endemic in Cotton Board/Lake Vic Co-op Fed and successors from late 1960's and attempts to stamp it out failed through early 1980's. Barring an intrusive, abrasive audit we dare not assume all is well now!).
11. A comprehensive TAC audit is needed on all crop marketing companies (albeit not urgent on Coffee where situation has always been under control). There are late accounts; there has been 'conflict of interest' especially involving TFA-TCA and

Officials/Directors of both; doubtless efficiency could be raised. But TCA has been financially viable, has relatively low costs given context and does not reach 75% export payout to farmers because there are weight losses and processing costs making this quite impossible for anybody barring either 50% cut in time from purchase to sale or 50% cut in interest rate or both; conditions well beyond TCA's ability or duty to achieve!).

12. That audit is discussed in separate memo on regularizing government Capital Transfers to Parastatals/restructuring Parastatal Finances. What follows here are points specific to crop marketing companies:
  - a. Balance sheet on realistic valuation existing assets and checked total liabilities (ie. creditors accounts may not be fully recorded - as discovered in earlier NMC inquiry);
  - b. Profit and loss estimates for 1986/7; 87/9 and projections-preliminaries for 89/90 and 90/91 specifically breaking down costs into:
    - i. Crop Purchases
    - ii. Associated Expenses (including any input subsidies or extension specifically identified)
    - iii. Transport
    - iv. Processing
    - v. Storage
    - vi. Administration
    - vii. Selling
    - (viii) Operating Surplus (revenue less above)
    - ix. Interest on overdraft equal to average rates value of stocks (or interest actually payable if that is lower as it is for TCA)
    - x. (viii - = Current operations result)
    - xi. Interest on past losses
    - (xii) Book loss (or profit if x positive and xi low or nil-)

Note - For a/b the accounts of main subsidiaries (eg. TCA's coffee curing and coffee marketing companies) should be consolidated into the main company's account.

Note - NMC needs to have intra year reserve accounts (purchases-cost including interest and storage-sales-loss) totally separate from basic accounts. Treasury should (on basis NMC Budget) budget in advance for this loss and correct iv March for actual level which depends largely on weather and cannot be projected accurately in the previous March/May.

- c. A rough efficiency audit on actual unit costs of each of i-vii compared with reasonable levels (and with each other).
- d. An assessment of whether 75% payout rule of thumb is rationally attainable for crop in question and if not what is! Basic technique:

Run model

- A. Revenue at probable volume/price
- B. Less ii-vii plus ix at estimated efficient operations level
- C. Leaving amount payable to sellers to marketing company
- D. Divide C by A to arrive at target %.

With present transport costs - speed (or absence thereof) - interest rates I doubt 75% is attainable, especially if significant processing costs.

Note 1 - For cotton "A" (revenue) should include cottonseed. Excluding that item totally confuses true payout %.

Note 2 - The approach above avoids recurrent errors from comparing unit price of less bulky processed form with unit payment for heavier unprocessed.

- 13. Once # 11 is done it is possible to see:
  - a. present basically irrecoverable debt (all in excess of stocks of crops and inputs)
  - b. desirable 'leeway'/equity - (to reduce debt to 75% of stocks of crops and inputs)
  - c. amount (from a and b) to transfer, to 'Residual Credit Recovery Company'

- d. possible target payout % (to growers or more accurately to unions or primary societies) % and target cost levels;
- e. where management was hopeless and where reasonable on current operations.

14. The next steps would be:

- a. If management hopeless (incompetence or corruption) NBC/RCRC install Receiver/Manager with full powers to sack any (or all) managers;
- b. if technical - operational management OK but not financial NBC/RCRC install Finance Manager/Chief Accountant/Internal Auditor;
- c. Then uncollectible portion of debt per 12-a/b goes to RCRC. BOT to own RCRC and to reduce its claims on NBC by the amount transferred;
- d. RCRC to be paid 50% of marketing company surplus after interest on non-transferred debt (and depreciation). This will be applied to principal (the 'loans' will have to be non-interest bearing). Nominally this claim will last until debt fully redeemed but provision to be reviewed in 5 years.
- e. Treasury to pay to RCRC:
 

.1990/1	1%	total	RCRC	'Assets'	acquired
.1991/2	2%	"	"	"	"
.1992/3	3%	"	"	"	"
.1993/4	4%	"	"	"	"
.1994/5	5%	"	"	"	"

to go towards reducing principal.
- f. If total TSh 25 billion the Treasury charge will be TSh 250 million rising to TSh 1,250 mn and totalling TSh 3.750 mn over 90/91-94/94 plus say TSh 500 mn under "d" leaving a balance of TSh 20.75 billion. If review decides 6%-7%-8%-9%-10% over 1995/6-1999/0 from Treasury then in 2000 balance would be TSh 10.75 billion minus 50% of surpluses or - say - TSh 10 billion. (The % is on 'assets' 'acquired' by RCRC not reducing balance).

15. Legally the above is practicable:
- a. TAC Amendment 1972 (74?) for Special Audit is so draconian as to allow inquisition proposed. MF has power to advise President to activate;
  - b. NBC could legally call in the overdraft balances and then (when not paid) put in receivers and managers. So the crop marketing companies and co-ops needing RCRC help can be forced to sign contracts giving NBC/RCRC powers to put in Receiver/Manager or Finance Managers (per para 13-b) in return for NBC not putting them into receivership and RCRC taking over/halting interests on part of overdraft. This power could be expressed as lasting until RCRC balance for a company was 0. (About 2005 if only Treasury paying-much sooner if company has high surplus to pay 50% of to RCRC).
16. Practically the above should allow facing reality; distributing burdens; forcing accountability;
- a. Possible targets set for (MC's) and debt that would prevent reaching them peeled off;
  - b. NBC left with 'viable' debt and duty to manage/monitor it;
  - c. NBC/RCRC given power to take over management now or any time in next 10-15 years when it went badly wrong;
  - d. BOT to take over 'paper problem' from NBC so later is not bankrupted by unsnarling CMC's;
  - e. BOT looses interest (as does NBC) but Treasury plus CMC set it whole on nominal principal so it can carry RCRC on its books at face value.
- Note - a. RCRC is not a bank so this reduces bank credit outstanding so long as BOT "asset" for RCRC is treated as an 'investment' not an advance;
- b. The inflationary damage/real resource loss came when losses were made - to try to claw back fast would be grossly deflationary;
  - c. the proposed method clears decks for same operations with 'real' accounts from now on.
17. This is urgent. Should be completed by 31-XII-90 with vesting retrospective to 1-VII-90 (1990/91 budget year).

Co-ops (Regional Unions)

18. Directly analogous to CMC's.
19. For largest 5 debtors (excluding Kilimanjaro, Arusha, TFA which look solvent) same procedure as CMC: on same time scale.
20. For other non-performing co-op feds same procedure but during 1-1-91/30-VI-91 as they represent far lower sums.
21. Note - same Receiver/Manager or Financial manager provisions should apply. Co-ops are in law private enterprises with no immunity from such sanction. Doubtless NBC/RCRC should liaise with registrar of co-ops and if appropriate use his people but he should not be allowed to screen the unions.
22. The whole co-op structure needs to be revamped by 31-XII-90 to give accountability and some guidelines;
  - a. Estimation what necessary margins for Unions and Primary Societies are. Estimates are needed for at least top 10 unions plus 11th for smaller ones and for say 10 different ps groups by financial and geographic scale. This gives rough yardstick against which members, Registrar, Kilimo, NBC, RCRC can measure results;
  - b. All Primary Societies should elect boards (one member one vote) with not less than 10 voting electees and not over 3 non-voting ex-officios. These boards should determine by 31-XII-90 whether to continue or terminate managers (with no severance payable as de facto managers as a group appointed themselves).
  - c. In January 1991 all Unions should have general meetings with 1 or 2 (depending on size) voting members per ps plus 1 non-voting advisor to ps' members (manager or A.N.Other as ps' board decides). No ex-officio votes. Meetings should be given latest accounts (in all possible cases with TAC audit) and have power to continue or terminate (without severance) managers.



- d. Primary Societies as of 1-V-90 should have power to sell crops to:
- i. Own region's Union
  - ii. Any other Union
  - iii. Crop Marketing Company
  - iv. Regional Trading Company (their own or other region)
  - v. Government entity and/or
  - vi. Manufacturer using the crop (eg. cotton lint to Texco or Cashew to processing company) at the option of the primary society.

Peasants have wanted this since 1972! Let us at long last respond. With "c" it should give peasants "leverage over managers and unions" where now they have damm all.

#### Privatising Crop Marketing Ending Marketing Losses

23. Ending losses does not require privatisation. Privatising by itself will not end losses.
24. Thanks to the Marketing Development Bureau's advice on and oversight of (supposed to be overseeing but ...) Crop Authorities over 1975-79 we have built in structural losses. (Before losses were not general and permanent. Indeed in 74/75 overall probably surpluses. The manic destabilisation boys created the mess). That is what IMF means when it says DCF overshoot is "structural"!
25. Recreating Co-op Unions did not help. Indeed it was so handled as to raise costs, reduce accountability, shift losses (in part) from CA's over whom Treasury was getting some grip at last (and whose losses it had begun to pay) to Co-op Unions whose finances were not really monitored and fell on the NBC as rising (worthless) overdrafts! Facile descensus avernum or "The road to Hell is paved with good intentions" and lousy, ill designed articulation.

26. Privatising by itself will not do any better. It would require a tremendous expenditure of political capital and private sector a) has not capacity; b) would "pick eyes out of business" ie. not serve more scattered, smaller growers.

27. The problems are:

- a. No yardsticks for reasonable efficiency costs (last ones were early 1970's - Kilimo and CA's/Co-ops under brutal Treasury pressure);
- b. No monitoring of performance (Kilimo declines to in MDB tradition; Registrar of Co-ops hasn't staff; Treasury lacks legal base - maybe - and specialist personnel - certainly; NBC - like Treasury);
- c. Appeal to political level that more credit or cannot buy crops/pay peasants will get order to NBC to shell out whether it is CA/CMC, co-op union or large private trader crying out. And, to be fair, failure to buy on time for cash does do economic (lower output, higher wastage), social (food security), external balance (exports), human (loss of peasant income and political (loss of confidence in state ability to cope with problems it ought to be able to control/resolve) harm.

28. Therefore the book clearing/accountability/receivership sanction route of previous two sections is essential to halt our chief post 1982 engine of monetary inflation - crop marketing losses. If that can be done:

- a. Inflation would fall - probably by 5% per year (total not each year);
- b. Domestic credit targets could again be met (broadly speaking they were met or nearly met 1971-1977).

This is technically feasible. It should be politically popular - CMC and co-op managers are not much beloved of peasants or wage earners or self employed poor people! Nor are they the darlings of most government officials or party functionaries.

29. I do not advise privatisation (beyond co-ops which are private) at this stage. One must end the systemic structural deficit first. Time then to consider what private role broadening (beyond co-ops) would be useful.

#### Other 'State Sponsored' Bad Debts

30. These are smaller than crop marketing and less systemic in impact. There are doubtless several but two stand out:
- a. Tanzanian railways;
  - b. TANU/CCM enterprise.
31. Railways restructuring is covered in memo on Government Transfer/Parastatal Financial Restructuring. Basically its "excess" overdraft (probably all present overdraft) should be transferred to RCRC. When that is done a new (say \$1 to \$1.5 million) overdraft should be opened and monitored by NBC like any other account (including saying - No).
32. Party enterprise. This is bankrupt. It is not clear why TANU and CCM have thought Party should run enterprises or could make surpluses to finance Party from them. The 1960-90 record surely should by now convince CCM it is a thoroughly bad idea!
33. The enterprise should be put into (quiet) voluntary liquidation. At the end of this there will be a large deficit. (Large relative to overdraft). In respect to NBC, RCRC should take over the claim and collect its share of liquidation proceeds. How balance is to be repaid to BOT is not clear:
- a. Treasury could pay in same 1%, 2% etc. formula as proposed above; or
  - b. Party could do so (out of its budget which de facto means out of funds voted to CCM in national budget).
- My own preference is "b". That however, is practicable only if the discussions of having multiple parties are unlikely to result in implementing multi-party system before 2000. (That

is not BOT, or NBC's or Hazina's business to decide but it needs answer from President/Chairman as if likely to be more parties than one by 2000 it is desirable to fall back on "a").

34. NBC should prepare a list of other bad debtors it claims were kept going over its written protest (documents produced) by state intervention. BOT/Treasury to judge which claims are valid - TAFICO probably is, TFC is not. Bora is not. These should then be handled analogous to Railways but not before 1-I-91/30-VI-91 unless it is easy to see liquidation is only answer (for TAFICO it is) and should be set in train by NBC/RCRC putting in Receiver/Manager to sell off, liquidate (probably privatise bits of TAFICO) as soon as possible. The delay is phasing to avoid hopeless overload while the larger bad debtor cases are handled.

#### Other Loan Losses

35. NBC should prepare a list of all accounts (performing and otherwise) of over TSh 1,500,000 outstanding (\$10,000) in two stages:
- a. Over TSh 15,000,000 by 1-IX-90.
  - b. TSh 1,500,000-14,999,999 by 2-IV-91.
36. In each case it should:
- a. Show outstanding;
  - b. Propose specific provision if any, to be deducted from outstanding for balance sheet purposes;
  - c. Justify that amount (including why any specific provision for performing accounts);
  - d. To extent BOT/Treasury agree with "b" - whole or part - write down reserves (starting with hidden reserves if any);
  - e. Be allowed to deduct these approved specific provisions for tax purposes;
  - f. Be required to propose how to deal with future. For all private and smaller parastatal accounts if it proposes other than calling overdraft putting in receiver/manager

and selling as a going concern it should be required to give justification;

- g. For bigger parastatals - BORA, TFC are examples - may still need to liquidate (purchaser would be a new parastatal or preferably joint venture buying all assets on ongoing business basis) but need Treasury/TAC guidance.
- h. Some larger parastatals will need financial restructurings as proposed in Government Transfers/Parastatal Financial Restructuring memo. Here NBC should share in loss perhaps by converting a portion of overdraft into equity which it would be free to sell to anybody (subject to general restrictions on sales to non-residents). If this gives a private minority holder - OK because it will have that result only if private partner knows from talking to management it will have a role beyond portfolio investor. NBC to take losses when it sells shares; required to sell within 5 years. (If nobody else will buy could provide Treasury registrar will buy at 25% below book value as of date NBC received them which will be near damm all in such cases!).
37. Making NBC meet these losses will warn it to be careful in loan credit management. And it does have reserves to cover these when devaluation - crop - other 'state influenced' losses are stripped out. (That by the by is a highly creditable performance given 1978-1981 economic decline and uneven, slow 1984-1989 recovery! Miles better than Midland or Standard or Continental Illinois or Bank of America!!).
38. When this entire (all four categories of bad debt) exercise is well under way - say as of late 1990-NBC should draw up draft revised balance sheet to see what % reserves not specifically allocated to impaired assets are of slimmed down assets (excluding Fixed assets, deposits with BOT, government paper).

39. The goal for 1995 should be:
1. Equity and retained earnings 5.0% of all assets;
  2. General loan loss reserve 5.0%; 3. to the extent that 1-I-91 pro forma is below this NBC should set targets:
    - a. all new specific losses to be met annually from that year's earnings;
    - b. general reserve to be increased parallel to assets out of post-tax profits;
    - c. 80% of post tax profits less "b" to go to retained earnings (or getting reserve to 5%) until 7.5% (and 5.0%) goal met;
    - d. other 20% to go to dividend.

Example

1-1-91 (000,000)

eg. Assets - TSh 40,000	Deposits - TSh 30,000
(of which TSh 35,000	Other Lia. - TSh 6,500
need reserves)	Equity/RE - TSh 1,750
	Loss R. - TSh 1,750

- . E/RE are 4.375% not 5%.
- . Reserves are 5% of relevant assets.

91 Calender Year Part L

. Pre Tax - Pre Write-off Surplus	TSh 1,750
. Specific Loss Allocation	<u>TSh 100</u>
. Taxable Profit	<u>TSh 1,650</u>
. Tax	<u>TSh 750</u>
. Post Tax Profit	TSh 900
. Added Reserve (5% on TSh 7,000	
asset increase)	TSh 350
. Balance	TSh 550
To RE	(440)
To Dividends	(110)

1-1-92

Assets - TSh 47,000	Deposits	36,000
(of which TSh 42,000	Other Lia	6,710
need reserves)	E/RE	2,100
	Loss R	2,190

. E/RE are 4.66%

. Reserves are 5%

Note - This requires a broad interest spread because rapid asset increase soaks up lots of post tax profit to hold same %'s'.

AnnexTFC

1. Tanzania Fertiliser Company needs a rapid assessment:
  - a. Does it have a cash flow operating (pre interest, pre depreciation) surplus?
  - b. does it save a substantial amount of foreign exchange?
  - c. if (a) is no and (b) is no then why not close it down ie. liquidate with no attempt to find/fund a fertiliser producer buyer of plant?
  - d. what would rehabilitation cost? What would (a), (b) answers be after rehabilitation? Can grant of very soft loans funds be secured for rehabilitation? Given improvement in (a) and (b) from (after) rehabilitation and the capital and forex needed to rehabilitate are the incremental ratios such as the justify rehabilitation? (If no closedown is quite near as major work will be needed to avoid derilection or skyrocketing costs).
  
2. NBC should live a consultant (local if possible ) to carry out study. Should have it by 1-X11-90. (TISCO? IFM? or TISCO/IFM?)
  
3. NBC-Hazina-BOT-Industries should then determine way forward:
  - a. put in NBC receiver and liquidator to sell assets;
  - b. put in NBC Receiver and Manager either to:
    - i) supervise recapitalisation and upgrading management.
    - ii) handle sale to new parastatal joint venture fertiliser company.
  
4. If TFC is worth saving I advise 3-b-ii:
  - a. it wipes out Klockner (equity partner)
  - b. it shares losses among NBC, other domestic, foreign creditors;
  - c. it gives new company a going concern (semi going) without liabilities or management/sales/supply contracts.



5. If we take that route TDFL should be hired to handle setting up, finding partner for "new" TFC. (TDFL would look to CDC - which has wide experience in half-privatisation/derilect firm revival work - to provide external expertise and hustle up a partner).

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01-02-90

GOVERNMENT TO PARASTATAL FINANCE: Implementing Orderly Process (Plus  
PARASTATAL FINANCE RECONSTRUCTION)

Notes by R. H. Green

1. It has been agreed for almost 20 years that all government resource transfers to parastatal enterprises should be identified as:
  - a. general start-up or temporary operating subsidies;
  - b. special agreed payments for non-economic services;
  - c. capital (equity or loan finance)
2. Of these "a" and "b" should be included in the Recurrent Budget while "c" should go into the Capital (so-called Development) Budget. Further each item in the Development Budget should be specified as to break down into equity and loan and as to terms of loan in tentative form in the Budget and in final form within 12 months.
3. Unfortunately this agreed (and re-agreed periodically) policy has never been followed. Many parastatals have large items of "grants", "transfers", etc., on their books dating back in some cases two plus decades.
4. This sloppiness is costly. It has clearly encouraged irresponsibility by some parastatals who mean it when they list these capital transfers as "grants"! It has hampered Treasury management of its investment portfolio. It has - sometimes - given too much no required payment funding (de facto equity) versus interest bearing repayable (i.e. loan) funding. Loans could be offset against borrowings as reducing government net borrowing as monitored by the IMF.
5. Halting the process of faulty transfers can begin as of 1990/91 Budget. Sorting out the past will take longer.

6. The format for 1990/91 on, should be:

a. All Capital Budget transfers to parastatals should specify:

- i. total amount;
- ii. equity amount;
- iii. loan amount.

b. Standard loan terms should be:

- i. 15% interest plus 10% devaluation fee annually but:
  - . interest and fee capitalised (added to principal) until project comes into operation (25% a year add on should encourage speed in completion and deter premature drawings);
  - . interest in years 1 to 3 of operation may (Treasury/parastatal negotiation) be partly or fully offset by an "initial operation" subsidy in the Recurrent Budget (the point of collect and repay is transparency of the subsidy);
  - . the 15% plus 10% total annual charge will be reviewable every 5 years (interest rates and devaluation costs may fall by 1995 and/or rise over some future period).
- ii. 3 years grace on principal from date project/plant comes into commercial operation (adjusted to fit semi-annual payments, i.e. nearest six months) with repayment in annual instalments over 10 years. (Probably means typical loan life 15 years from drawing average weighted maturity 10 years, i.e. 5 years at 100% and 10 years at average of 50% outstanding.) In specific cases longer (or shorter) repayment periods should be negotiated;

iii. devaluation risk to Treasury account.

c. The loan terms to parastatal do not depend on source of funds. In practice Treasury onlending will be of soft money (3% or under interest, 15 to 20 years or more to repay). With 25% annual

charges the devaluation cost should be more or less covered. And the cash flows on repayments should more or less match.

- d. the loan charge rate should be lower if for specific agreed reasons it is not desired that the parastatal earn over 25% operating profit on the resources. Two types of case arise:
    - i. Small Scale Agricultural and housing lending. (Here 10 grace + 20 repayment loans and 0% interest plus 10% devaluation 'insurance fee' may be suitable;
    - ii. Railways (which are supposed to have external economies and nowhere earn 25% nominal on assets anywhere in world) for which at present a similar 0% interest plus 10% devaluation charge and 10 + 20 year format would seem prudent.
  - e. no funds should be released to a parastatal until it has signed loan and equity agreement.
  - f. equity should result in shares issued to Treasury within 3 months of resources being drawn down (changing parastatal Acts and Articles where needed to permit this);
  - g. failure to issue contract and/or pay interest and principle as scheduled without negotiated rephrasing to be pursued by Treasury in same way as failure to pay tax.
7. The equity/loan mix for a parastatal is really a matter of total structure not that for any project. However, it is arguable that except under special circumstances the ratio for projects should be about the same as overall target. Some rules of thumb (may not apply in specific cases but can be starting points) are:
- a. Financial Institutions
    - i. Commercial Banks - equity and retained earnings at least 5% of total assets (treating assets and retained earnings as net of loss reserves);

- ii. Other - equity and retained earnings equal to 25% of fixed assets and 7 and one-half per cent of other assets;
- b. Public Utilities (Rail, Electricity Water, Harbour, P and T)  
Equity and retained earnings at least 20% of total assets (NB with assets valued at replacement cost less wear and tear).
- c. Trading  
Equity and retained earnings at least 20% of stock in trade and 30% of other assets
- d. Other  
Equity and retained earnings at least 30% of total assets.

Note - Housing would normally fall in "b". However, there is no hope of low cost housing earning operating profits over 5%. Therefore for NHC a possible target structure would be:

- 50% equity, 50% 10% income (if earned) notes 20 years grace plus 30 to repay

and for a reconstituted "Amenity Housing and Commercial Premises Corporation" (ex Registrar of Buildings)

- 50% equity, 50% 15% income (if earned) 5 + 20 years  
But I would advise selling off the assets of the "AHCP" and winding it up. First preference to occupiers; Second to buyers who would occupy all or majority of building they buy; Third to Housing Co-ops; Fourth, other domestic buyers.

- 8. For a start the ratios in #7 can be used on new (1990/91 and after) funding. But on total new funding:
  - A. Own Resources
  - B. Domestic Borrowings
  - C. Direct External Borrowing (normally to be discouraged)
  - D. Treasury Equity/Lending

For example, if a project including working capital is to cost TSh 1,500 million (\$10 million) for a manufacturing company the makeup should be 30% (TSh 450 m equity and TSh 1,050 m loan) e.g.:

A. Retained Profit of Ongoing Activities While Project Implemented	TSh 175 m
B. TIB Long Term Loan	TSh 500 m
NBC Overdraft Increase	TSh 100 m
C. Nil Direct External Loans	
D. Treasury	
i . Loan	TSh 450 m
ii . Equity	TSh 325 m

Equity - 30% (A + D ii)

Treasury is about 40% equity 60% loan because it is overall balancing source.

9. The clean-up of past should be done by TAC - for major parastatals over 1990-1991:
  - a. produce meaningful balance sheets revaluing usable assets at replacement cost less wear/tear/deferred maintenance and writing off other assets (including plant unlikely to be usable again as well as bad receivables);
  - b. 'revalue' any external currency (or devaluation guaranteed) liabilities at present TSh equivalent;
  - c. find out the proportion of debts, equity and undefined "Government Transfers";
  - d. Unless it produces an equity to assets ratio of well over 50% convert all "Transfers", "Grants" to equity (or if there are large accrued losses, i.e. negative retained earnings, use portion necessary to write these off). In cases which this would yield such high equity ratios convert excess amount to 10 + 20 year, 15% loan stock (no retrospective devaluation insurance) which makes final ratio 50% equity plus retained earnings/50% liabilities;

e. If revalued liabilities exceed revalued assets immediately begin an exercise to determine:

- i. should enterprise be salvaged? Why? (Answer may be Yes, e.g. Sao Hill - exports, debt all or almost all govt. guaranteed; Railways - necessary service. But don't assume answer Yes. For example, TAFICO should be wound up or sold. Should have been in early 1970s.)
  
- ii. If No can its assets (stripped of liabilities) be sold -
  - . to a private purchaser
  - . to a joint venture
  - . to a profitable parastatal in same line of business and the shell company (after asset sale) liquidated? Loss makers not vital for other reasons should not be left to lose more money. They should be put out of misery - preferably by selling assets.
  
- iii. if Yes (salvageable) how:
  - . by existing company with management and funds injection?
  - . by bringing in joint venture partner (domestic where appropriate)
  - . by selling as going concern with liabilities
  - . by selling assets only and liquidating shell?

The Treasury/TAC/Holding Companies cannot be company doctors for all sick parastatals. They do not have capacity. But sale now is likely to be at too low a price. Thus a joint venture approach (say 50-50 the JV partner to bring in new 50% - in forex if a foreign firm and partly in forex if a domestic but in latter case no questions on source, i.e. don't threaten prosecution because repatriated assets should not have been abroad or they'll vanish!).

iv. In reconstruction either new money (preferably dominantly equity!) or writeoffs of liabilities to Treasury or conversion of liabilities - e.g. to TIB - to equity or all three will normally be needed.

10. The above exercise is evidently broader than simply sorting out past Treasury "advances" to parastatals. It is important and urgent to allow a clear picture of status quo and provide a basis for systematic re-capitalisation/salvaging/sell off/liquidation. It cannot be done by present Hazina staff. One approach would be:

- a. have Treasury supervision/strategic direction under Commissioner Policy;
- b. hire TAC to do actual case by case work in coordination with CP;
- c. secure Technical Assistance for TAC - ideally from the Swedish state holding company which has during the past decade conducted a similar (if less desperate exercise);
- d. try to get ta to pay TAC fees (preferably not from World Bank or it will delay matters for 12-18 months arguing about parameters of exercise!).



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24-I-90



## DEVALUATION COST ALLOCATION AND MANAGEMENT

Notes by R. H. Green

1. Devaluation costs are the largest single threat to the viability of NBC, potentially TIB-TRDB-TDFL, Southern Pulp and Paper, TPDC and certain other enterprises. For this group present losses (rewriting liabilities at current exchange rate) are of the order of Sh 80,000 million for NBC and Sh 120,000 million for the group (netting to avoid double counting). Over the next 3 to 4 years they can be expected to double (arrears and even current payments on most of the overhang cannot in fact be remitted and an exchange rate of Sh 300 = \$1 will be reached in 1992-93 barring remarkably rapid decelerating of inflation in Tanzania). These figures exclude Government/BOT losses.
2. These losses do not, with few exceptions result from imprudent actions by firms, but from government policy which could not be predicted by firms at the time they undertook the liabilities. In a large number of cases there is no way the affected firms can pass on the costs (and if TIB and TDFL do this it is likely to bankrupt their clients rather more than to avert losses to themselves). Only in the case of long term loans being repaid by enterprises either operating at/near rated capacity or increasing capacity utilisation speedily is it fully practicable to claw back added TSh costs of servicing external borrowings by price rises parallel to the general COL increase. The most clearcut example is TANESCO.
3. This background strongly suggests that - except for the bearable out of domestic price increase portions of loans - the cost of devaluation should be transferred to the BOT/Treasury. In practice the quick transfer can only be to the BOT "Revaluation Account" because agreement with the IMF is needed if the Treasury is to issue government securities to reimburse the BOT and a very long run if it is to 'pay off' the loss in Real Recurrent Budget transfers to BOT.

4. Because devaluation will have to continue at least until Tanzania can reduce its inflation rate to or below the weighted world average (which is unlikely to be much over 5% in the medium term) whatever formulae are adopted should deal with the allocation of costs of future devaluations (not necessarily on the same basis as past ones).
5. For the NBC, perhaps TIB and TDFL and several enterprises (e.g. Southern Pulp and Paper, TPDC) it is urgent to act promptly. In certain other cases an audit is needed to determine either what proportion of losses need be transferred or that the enterprise is irretrievable in any case and should be liquidated (without prejudice to whether the buyer of assets should or should not continue production). That exercise should be completed within calendar 1990.

#### NBC

6. NBC has of the order of TSh 75,000 million devaluation losses on its books in a complex semi-transfer to BOT. This should be simplified:
  - a. all arrears to go to BOT's revaluation account including non-performing commercial (i.e. overdraft) loans where NBC has not received the TSh. (In these cases BOT would inherit the claim and be free to proceed in bankruptcy against the debtor);
  - b. NBC would then have clean books up to effective date - say 30-VI-90;
  - c. future 90-180 day acceptances would be at NBC's (and borrowers, i.e. issuers) risk/cost. In practice there won't be many given risk to buyers and Tanzania's credit rating. But if TSh on new acceptances are paid to NBC and it has no forex to remit and BOT cannot cover the TSh (at rate of date NBC received them) and the future liability to pay go to BOT Revaluation Account (analogous to Treatment of Treasury debt service). This should be done by 30-VI-90;
  - d. longer term loans repayable in forex guaranteed by NBC should be paid by NBC at rate it is determined borrower can afford. The

extra liability to BOT Revaluation Account. (This will be part of exercise to end 31-XII-90 not 30-VI-90.)

7. Here as in other cases the practical points are:

- a. inequity and inefficiency of bankrupting an otherwise viable enterprise because of forex devaluation fire storm;
- b. fact that a Central Bank can have phony asset ("Revaluation Account") equal to over half liabilities whereas normal enterprises cannot;
- c. problems of government immediately reimbursing BOT, partly re interest cost if securities are at normal interest, but primarily because of IMF ceilings. (The BOT Act limitations could be surmounted by amendment but getting IMF agreement to - say - TSh 150,000 million government paper now with more to come will be rather harder despite fact these transactions do not affect real resource availability or demand directly at all. Devaluation loss like crop marketing loss has its impact when - if - real payments are made abroad not later when books are straightened out.)

TDFL, TRDB, NIC

8. The exposure of these institutions to devaluation losses is unclear:

- a. many of their TSh loans out of foreign loans are covered by contracts passing the devaluation risk to borrowers;
- b. however, that contractual safeguard will avail them little if the borrowers are bankrupted by seeking to meet the current TSh equivalent of their de facto forex denominated loans;
- c. TIB, TRDB, etc., have to a large extent (not totally, especially in TIB case) received forex loans via the Treasury and have not in general accepted the devaluation risk on these (indeed these transfers have usually not been formalised as loans or equity at

all and incongruously appear on the books as "grants" or (less bad) transfers!

9. The first step is to discover the extent of net losses to date (realised and accrued) and probable losses to come assuming TSh 300 = \$1 in mid-1992 and TSh 375 = \$1 in mid-1994. (That assumes slightly over 20% annual devaluation to mid-1992 and 10% annual thereafter or domestic inflation rates of - say - 22% and 12% respectively.) For this purpose devaluation risk is to be assumed to be where it now lies contractually, i.e. that financial institution loans with devaluation guarantees will be repaid; that when payments are due and made in TSh by the institution losses from delayed remittance fall on the BOT revaluation account; that on lent or on transferred Treasury funds are repaid at their TSh face unless (as I believe is not true in any case) the Treasury did insert a devaluation adjustment clause.
10. These losses should be transferred on bloc to BOT Revaluation Account to clear the financial institution books. That stage of the exercise should be completed by 30-VI-90. (These institutions have relatively good books and accounting capacity and few judgemental calculations beyond the exchange rate projection one needed.)
11. But a second phase is needed. This is to calculate what borrowers can repay without bankruptcy. In many cases this will not be the TSh equivalent of loan at current/future exchange rates even though the loan contract provides for that.
12. That exercise should follow detailed examination of major borrowers (see section below) by TAC for Treasury-BOT-Lenders and of others by the lender to be concluded by 31-XII-90. The results will be unpleasant but whether the losses are Sh 3,000 million or Sh 10,000 million is, without more data, anybody's guess. (The Southern Pulp and Paper exercise should be carried out separately as there a total capital reconstruction is needed and the devaluation loss needs to be considered in that context.)
13. When the second stage (Para 13) exercise is completed then the loss should be transferred - in whatever way is most convenient - to BOT

Revaluation Account. How is not quite clear here or with first transfer as these firms (unlike NBC) do not have substantial obligations to the BOT. One way would be for the Treasury to write off loans and transfers (which are de facto equity) to TIB, TRDB in return for BOT cancellation of equivalent value of Treasury bills transferring that equivalent of devaluation loss to Revaluation Account. (That has the advantage of lowering banking system net lending to Government.) That will not work for TDFL and there a deposit with BOT drawable only on an agreed time profile and non-interest bearing may be needed.

14. In theory TOFL should be treated differently as 75% of the equity is foreign (CDC and Netherlands plus German analogues). In practice no dividends are paid (and no significant ones ever have been or are ever likely to be). Therefore a better option would be to propose:
- a. government (BOT) make good devaluation losses;
  - b. in return \$5 million new equity be issued to TIB;
  - c. and each other shareholder subscribe \$2.5 million new equity.

That would raise TIB's equity share from 25% to - say - 35% and would bring in \$7.5 million in de facto future cost free forex radically strengthening TDFL's capital structure. As TDFL will be bankrupt if nothing is done (it has large forex obligations and many of its borrowers cannot repay loans borrowed at Sh 10 to Sh 30 to the \$1 at Sh 150 to Sh 300) the proposal should be viewed as equitable by the outside shareholders. (If agreed the approach should first be made demi-officially to Alistair Boyd, now I think Sir Alistair, Deputy Managing Director CDC.)

#### Supplier Credits for Stock in Trade

15. The main case here is TPDC. It was required to buy oil on 1 to 3 year external bank credits even though it had the TSh to pay cash. The purpose was to save forex. The credits were then defaulted (so

far as lenders were concerned) even though TPDC could pay the TSh equivalent on time.

16. Some interim measures and clawback funds have been set up but it is desirable to make a general solution. Its principle should be to avoid damaging TPDC which is a totally innocent bystander who took the credits as a result of a Government/BOT decision and has been unable to pay effectively when due because BOT/NBC had no forex to remit even though TPDC did have TSh.
17. On the past, an exercise should be conducted on all TPDC oil credits from - say - 1980. The TSh borrowed; the TSh payable if forex had been available to pay as per contract; the present (paid plus unpaid) TSh equivalent of credits. TPDC should pay the second amount, i.e. TSh equivalent assuming BOT/NBC had accepted payment and remitted on due dates. (TPDC has in fact paid some amounts at higher rates and some of its payments are in NBC 'unremittables' to be transferred to Revaluation Account under earlier proposals.) The amount not yet paid (i.e. the amount computed less already paid) should be an obligation to BOT which then assumes obligation to pay off outstanding credits and interest thereon. Probably TPDC can pay this sum in cash as it has had substantial term deposits and Treasury security holdings.
18. Hopefully other Supplier Credits for Stock in Trade cases are either:
  - a. covered in handling of NBC 'unremittables' accounts; or
  - b. small enough to be absorbed by borrower.
19. Future use of term credit (over 180 days) for stock in trade should be discouraged. For example, the coffee export proceeds oil revolving credit should literally be cleared every 90 or 180 days because the TSh equivalent of any balance permanently outstanding will escalate and one cannot retrospectively raise the prices at which petroleum products or any other goods were sold. If such credits are used they should not be for over 366 days and seller should be encouraged to charge on basis that repayment in TSh will be 2.5% per month higher than TSh equivalent on date of borrowing.

(Where necessary Prices Commission should be instructed to approve calculations on that basis.) In no case should importer be forced to use such a credit facility. If that is not practicable, in the case of TPDC then it should be given a guarantee that it can repay at TSh equivalent of principal plus interest on date of borrowing + 2.5% a month cumulative to date of scheduled payment with any further TSh cost falling on BOT. If this were set up as a contract BOT would gain whenever cumulative devaluation was under 2.5% per month and remittances were made on time.

Long Term Forex Borrowings - Operating Enterprises (Public and Private)

20. Nominally a long term borrower can repay at new TSh equivalent of a forex denominated loan (from abroad or in a devaluation risk contract with TIB, TDFL, etc.) In practice this will rarely be possible. For example, a loan taken at - say - Sh 40 = \$1 at 20% interest in 1986 would now cost 3.75 times as much to repay. On COL basis mid-1990 prices for goods and services will have risen about enough to allow receipts to be 1.85 times the levels when the loan was drawn. While some domestic costs are less than 1.85 times 1986 levels this does not provide adequate room to repay unless the firm has at least doubled output and raised capacity utilisation substantially.
21. The only way to conduct this exercise is case by case. As there is urgency and are - perhaps - 50 to 75 cases a possible way forward is:
  - a. Hazina (using TAC) handle
    - . Southern Pulp and Paper (with cooperation of CDC if possible);
    - . Railways, Harbours, P and T, TANESCO (albeit or because here main devaluation risk is on direct external borrowings);
    - . Any other parastatal with over \$2.5 million borrowings on which it has given a devaluation 'guarantee' directly to external party or indirectly by a financial institution.
  - b. TOFL/TIB (jointly or by agreed division) - all others.

22. Southern Pulp and Paper, which has \$200 million odd external loan liability exposure, is an ongoing disaster. A total financial reconstruction is vital but can as well be done over 18 months as over 6. How much of devaluation losses which cannot be recovered from operating income is to fall on whom needs to be negotiated among SPP-Hazina-NDC (or whoever is SPP Holding Co.)-TDFL-CDC-Main Lenders. Initially Hazina-CDC-TDFL in consultation SPP/NDC?) should prepare an agreed proposal.
23. But other SPP actions are more urgent:
- a. sorting out transport so enough at least semi-suitable rail wagons are available to move output;
  - b. securing (whoever ultimately pays - owns) appropriate railway wagons to move paper (many of present are inappropriate and damage the product;
  - c. sorting production snags (including debottlenecking) to achieve rated capacity;
  - d. setting up sustainable rotation to supply logs for "c" - probably including additional spending on roads, vehicles;
  - e. reviewing present selling strategy to ensure it can sell (largely abroad) total output (and if it is still not performing get new selling agent on an 'incentive' contract, i.e. no sale, no pay; better price, better pay).

Some of above has begun during 1989. How far has it gone? What is urgent now? \$250 million of investment and a potential \$50 m in annual exports is a macro priority to sort. NB - the Kenya analogue does make a profit. Thus, at least at operating level, SPP should be able to achieve a large surplus. Whether it can fully service forex debt is less clear, probably not. In all probability at present world paper prices and with delay in completion and slow output buildup there would be losses to refinance anyhow but in this case



little purpose would be served trying to untangle these from those relating directly to devaluation.

24. For the present SPP should conserve cash flow. That is operating expenses and essential debottlenecking have first claim and overdraft interest second. If that means not paying long term debt interest in full it should warn creditors at once and indicate restructuring option exercise is being undertaken and proposals will be made by, say, 1-IX-91. Clearly it should suspend long term loan repayments. It should not take on any new commercial debt including no increase in overdraft. If interim cash is needed (even after suspension of interest payments) then shareholders (in practice especially the Treasury) should provide them as no interest, two year or until after reorganisation, secured loans to be sorted into new capital structure.
25. It appears TANESCO can cover devaluation costs if it can get a rate adjustment formula so that semi-annually or annually it may adjust rates on basis
- $$\begin{aligned} & \text{(Old Rate) (.5) (Increase in Forex Cost)} \\ & + \text{(Old Rate) (.5) (Increase in COL)} \end{aligned}$$
- without reference to Cabinet or Prices Commission. I.e., automatic cover of 50% odd forex cost share in total costs for devaluation and of general local cost increase by use of COL (least bad index available). That means 25% to 30% annual increases at present devaluation/inflation trends but if these declined to 10% a year each so would automatic rate boosts.
26. Subject to review P and T and Harbours seem to be like TANESCO. This does need checking.
27. Railways is bankrupt and continues to lose money before interest even on historic (let alone replacement depreciation. A total financial review (see separate memo on Govt. to Parastatal Finance and Parastatal Finance Reconstruction) is urgent and essential. The first steps in any case are, as for Sao Hill, to sort out operations and revenues:

- a. to identify what is needed to restore 1970-75 average traffic levels (over twice present) and reduce turnaround times to plausible duration (e.g. in 1974 it took 8 days Bujumbura-Kigoma-Dar for coffee; in 1989 about 30 days);
  - b. to have specific targets/target dates to:
    - i. mobilise finance
    - ii. put works/equipment in place
    - iii. raise traffic volume/reduce turnaround time (annual targets by main route and cargo type)
  - c. to have monthly progress reports on "b" until Finance/Transport are satisfied "b" is an ongoing process and then quarterly ones;
  - d. restructure tariffs on a coherent, serious basis - rough-and-ready one by 1-VII-90; more sophisticated and lasting by 1-VII-91 with RR power given to raise average of all rates annually by COL without consultation with Prices Commission or Cabinet and within that average to have some leeway to alter relative rates for different products.
28. The above should begin to clear up operating and revenue disasters which have now lasted well over 15 years. But there is no reason, as yet, to believe present management can do the job. If they can, they do need, and know they need, specific additional planning, design, engineering, financial management and rate setting skills. They should be asked to specify these and Hazina should give priority to securing them (persons-systems-equipment) on grant or IDA type terms from Canadian Pacific or Canadian National Railways (i.e. Canadian govt. funding but contract with the Railway) or another country with physically and financially plausible railways (no not India). This team/backup unit is needed by 1-VII-90.

29. While Paras 27-28 won't 'solve' railway finances, they should:
- a. greatly ease transport problems by freeing lorries now tied up handling half of business which would go by rail if rail functioned properly;
  - b. reduce financial haemorrhage so operating costs (including maintenance) and most interest and repayment on historic TSh loan face could be met.
30. Until progress is made the RR may have a cash flow loss. It should not be allowed to raise overdraft with NBC further. It should be forced to justify cash flow loss quarter by quarter in advance to Treasury and then receive 2 year, no interest, secured loans. These would be put into new capital structure (realistically converted to equity).
31. From above it is only too clear RR cannot cover devaluation loss. Treasury should assume all RR external debt in return for historic TSh face obligation of RR to Treasury. Treasury should then negotiate with lenders:
- a. bilaterals - try to get writeoffs (where not already given) from sympathetic ones;
  - b. other bilaterals - into Paris Club maw. (a and b include supplier credits to RR guaranteed by Paris Club governments).
  - c. World Bank - convert RR debt which is ex-EARR Corporation (i.e. Community Debt Allocation) to IDA terms as of date of reallocation of debt (1984?). Bank is converting some old Bank loans to IDA countries to IDA, a few semi-retrospectively.
32. To extent TIB/TDFL will (on basis of results of Para 21 exercise) not be able to recover full devaluation cover in loan agreements then:
- a. agreed proportion to be charged to firm;

- b. balance to Revaluation Account BOT.
- c. by Hazina paying cash to TIB/TOFL and BOT 'reimbursing' by reducing Advances balance to Treasury and raising RA;
- d. each case to be a contract TIB (or TDFL/Their Borrower/Treasury/BOT).

BOT

- 33. The Revaluation Account of BOT will be increased virtually at once by Sh 90-100 billion and when all exercises are done by Sh 100-125 billion as of early 1990 with another Sh 100-125 billion to come over next 3 to 4 years as TSh declines increasing loss on present outstandings. This is in addition to its Revaluation Account items on own devaluation losses and on non-remitted Treasury TSh payments on external debt.
- 34. A Revaluation Account of over Sh 500 billion as of 1993 has no direct real resource implication vs leaving liabilities where they fall. Indirectly it should prevent loss of real resource flows from closures/liquidations of enterprises which are sound or salvable at operating but not external debt level.
- 35. But a Revaluation Account of TSh 500 billion with Other Assets of - say - TSh 100 billion (at least half domestic) and liabilities (dominately external) of TSh 590 billion has a certain surrealism. It cannot be allowed to go on forever. But its erosion must not be in a way which exerts excess deflationary pressure.
- 37. There should be an agreement that so soon as Treasury can balance Recurrent Budget from domestic revenue (i.e. Recurrent Surplus equal to Foreign Grants used on Recurrent Budget and stripping out loan repayment/loan rollover items which are capital) then Treasury/Hazina agree a growing annual Treasury contribution to writeoff. If by 1993/94 Budget one has not reached first payment this arrangement to be reviewed.

38. Note - part of Revaluation Account is nominal because part of External Liabilities will never be paid or will not be paid at face value. For example, anybody who believes the \$500 million commercial arrears will ever be paid will believe anything. (a. we have already paid many of the creditors in de facto 15% surcharges on their subsequent cash sales; b. bulk of arrears go back to 1979-1982 and creditors have de facto given up and written off on own books; c. Bank/Fund have acquiesced in permanent non-payment by not raising the issue of payment seriously over past 5 years). Thus over 1995/2005 one will be able to write down both sides of books but it wouldn't be prudent to try now nor could amounts be guessed (I'd hazard guess \$400 million commercial and \$250-500 million bilateral won't be paid which is TSh 97.5 to TSh 135 billion at TSh 150 = \$1 rate!).

#### Future External Borrowings

39. We don't want to clean up the past and promptly dig a new pit. Thus external borrowings should either be balanced by external assets (e.g. NBC should balance its loro and nostro accounts overall as fast as possible), be taken by BOT or Treasury on projection of probable future TSh cost of servicing or be specifically approved by BOT on basis statutory guidelines.

40. TIB, TDFL, TRDB, etc., may need external funds. If practicable the public sector ones should seek back to back loans - external lender to Treasury, Treasury to TIB, TDFL. Treasury would get loan (or grant) on as soft terms as possible and re-lend:

- 15% + 10% devaluation insurance for - say - 5 + 15 years (but always shorter than or identical to external loan)
- every 5 years the 15% + 10% to be re-evaluated on basis recent past, prospective rates of inflation and devaluation.

41. TIB, TDFL, TRDB should re-lend at 20% + 10%, the 20% to be reviewed every 2 years and to be raised/lowered on the following basis

- average rate of inflation past 2 and (probable level) next year 20% to 25% rate + 20% (+10%)

- . if under 20% then that is rate payable (+10%)
- . if over 30% rate to be 20% + (Actual Inflation Rate - 30%)
- . Devaluation premium to be 10% so long as average devaluation of past 4 years exceeds 15%. Once below 15% average over 4 years, the premium to be 10% or average of past two years whichever is lower, e.g.,

20 + 30 + 30 + 25 (Avg. 26.25)	Rate 10%
30 + 30 + 25 + 20 (Avg. 26.25)	Rate 10%
30 + 25 + 20 + 15 (Avg. 22.5)	Rate 10%
25 + 20 + 15 + 10 (Avg. 17.5)	Rate 10%
20 + 15 + 10 + 15 (Avg. 15)	Rate 10%
15 + 10 + 15 + 10 (Avg. 12.5)	
	(2 Yr.Avg. 12.5) Rate 10%
10 + 15 + 10 + 5 (Avg. 10)	
	(2 Yr.Avg. 7.5) Rate 7.5%

(As illustrated the 10% premium is likely to lead to high losses until the late 1990s barring a rapid fall in inflation. This ultimately would fall through Treasury on Revaluation Account of BOT but - hopefully - would be largely or wholly covered by spread between 0 to 3% interest and 15% re-lending, i.e. Treasury has - say - 22 to 25% to cover devaluation. As the rate charged borrower is 30% total it is implausible that full cost recovery insurance would be possible without deterring medium term investment.)

40. Operating parastatals should in general be required to borrow through Treasury or TIB/TDFL/etc. (90 day commercial credit/acceptances are a general exception especially if balanced by forex denominated receivables). Specific exceptions include:
- a. TANESCO (subject to its having secured a rate adjustment formula of the type proposed above);

- b. Harbours and P and T subject to determination that (as appears to be the case) they are able to cope with present forex debt service and projections for each new external borrowing of over \$2.0 million to demonstrate their continued ability to do so;
  - c. Export projects (e.g. Kilamco) which can demonstrate that forex costs can be covered from forex earnings (so devaluation gains and losses cross-cancel) and that tax arrangements have been made to avert having to repay external loans out of taxed profits above allowable depreciation.
41. Private enterprises should - as is now the case - have to secure permission from BOT to borrow externally. It should be given only when/to the extent that forex earnings would cover forex costs. Even then it should be made clear:
- a. no Tanzania public sector entity guaranteed the loan explicitly or implicitly - the creditor must look to the borrower and only the borrower for debt service;
  - b. pursuant to this NBC should be forbidden to guarantee foreign loans to its customers (not including 90 day acceptances);
  - c. Tanzania did not/could not guarantee that all debt service would/could be remitted as soon as TSh cover was provided and accepted no liability for any resultant losses which must be between lender and borrower.
42. Hopefully very few Tanzanian entities will be foolish enough to wish to borrow in forex and few external ones damn fool enough to lend to them! One problem is open book credit especially to subsidiaries, e.g. Fiat (T) from Fiat. This does not in practice require prior BOT approval because (it seems) that no method now exists for BOT to know (odd, as import licence presumably states source of funds). As the goods are likely to be sold well before remittance is made (is sought to be), substantial losses can arise. The real question is whether Tanzania should be greatly concerned - these credits are almost 100% to T subsidiaries of foreign companies and thus, on the face of it,

so do losses. But presumably - e.g. - Fiat (T) claws back losses on book credit balances by charging more now? It would be possible for BOT to require that all open book credits among group/associated companies to Tanzanian units be in TSh (i.e. devaluation risk on lender). But this will stop book credit stone cold dead (presumably new flows are very low now?). That will mean a once for all increase in forex needs to shift this working capital from open book credit to cash basis.



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24-I-90

P.S. In case of private - or dominantly private - enterprises there would be an argument for letting past losses lie with borrower up to date be paid TSh equivalent. This is not desirable as a general rule:

- a. as with parastatals, the unforeseen exchange rate evolution is not result of enterprise action;
- b. BOT approved the borrowing (e.g. in Embassy Hotel case which even prc major devaluations couldn't have broken even!);
- c. In virtually all cases NBC (most imprudently) but, with no serious Treasury/BOT queries at the time) guaranteed the loans;
- d. shutting down otherwise viable private enterprises is no more sensible than shutting public.

But some quid pro quo should be demanded for taking over portion of external loans enterprise cannot pay. (As these firms have more price flexibility they may be able to pay most or in some cases all.) They could be offered option of issuing equity equal in face value to portion 'written off' (taken over) amount to Treasury Registrar or to issuing a 3 year grace, 17 to pay loan (i.e. one-seventeenth each year 4 through 20) at 1% interest. Most, I think (hope?) would choose the latter course as the former would make Treasury significant or in some cases (e.g. Embassy Hotel) controlling



shareholder. The shares acquired should be sold for Hazina by TDFL (when a plausible price can be obtained) unless a special case for holding them exists (which is not very likely).

## MERCHANT BANK

By R. H. Green

1. A case for establishing a joint venture merchant bank exists:
  - a. a foreign enterprise partner would be hard to fit into TIB or TDFL let alone NBC;
  - b. a merchant bank lives by its wits as a catalyst not by its financial resources - TIB and NBC are the exact opposite albeit TDFL has some of this characteristic;
  - c. to raise foreign enterprise investment (including especially equity- management-technical partners) requires both (i) experience in doing that and (ii) knowledge of Tanzania and Tanzanian enterprises.
2. The possible parameters would be:
  - a. 50% foreign partner
    - . Preferably a successful Zimbabwe Merchant Bank (e.g. that of Zimbabwe's domestic commercial bank)
    - . Failing that a Swedish or Dutch merchant bank
    - . Third choice - Barclays (albeit I have doubts of their interest) or Standard and Chartered Merchant Bank (Standard and Chartered has sold off most of Standard Bank of South Africa so that barrier to using it would seem to be removed.)
  - b. 20% TIB
  - c. 10% TDFL

d. 20% NBC

(to give links to key cooperating financial institutions in Tanzania)

3. The financial structure might be:

a. Equity

\$20 million Paid Up

(Foreign Partner To Pay In Hard Currency)

(Domestic Partners To Pay In TSh)

b. Own Loan Capital

\$20 million at 15% interest via 5 year fixed deposits  
(renewable) from NBC, TIB, TDFL paid in TSh and invested  
ad interim in 2 Year Treasury Notes (assuming these do  
yield about 15% now).

Plus loans raised as and when needed for its own  
contribution to finance of projects it organised/catalysed.

4. The purpose would be to:

a. receive project proposals from enterprises, TIB, NBC, TDFL;

b. to devise possible financing packages;

c. to put together a package of finance (including foreign);

d. where necessary to use its own money (as equity or loan) to  
catalyse the package.

(It would normally hold equity until firm was profitable and then  
sell it at a profit in Tanzania to public, co-op or private sector as  
seemed feasible and appropriate.)

5. Advise TDFL commission a study on this preferably by having Hazina get CFTC support and using 3 consultants - 1.) IFM or U Dar; 2.) Zimbabwean; 3.) Person familiar with European Merchant Banking scene. Proposed timetable: Study by 1-III-91; Decision 1-V-91; Negotiate 1-XI-91; Start operations 1-VI-92.



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31-I-90

## BROADENING EQUITY MARKET

By R. H. Green

### Introduction

1. A stock market is an unlikely first step to broadening equity finance sources or raising more funds. To date no SSA stock market serves those purposes - they may make holdings resulting from large, high dividend company flotations a bit more liquid and attractive but not much more.
2. A more plausible first step would be to authorise NPF and NIC-Life Fund to hold up to 10% of assets and to invest up to 20% of net new assets (i.e. annual asset increase) in equity.

### NPF-NIC Equity Holdings

3. For NIC-NPF to have shares to buy someone would need to sell:
  - a. Treasury
  - b. TDFL
  - c. NDC/Other Holding Co's
  - d. Merchant Bank
  - e. TIB
  - f. Private enterprises - a real but probably limited source.
4. As each of these sources could use greater liquidity they have reasons to sell. As a rule of thumb "b", "d", "e" have no reason to hold equity when it can be sold at an attractive price. Treasury and NDC/other Holding Companies would logically be willing to sell down to a 51% (controlling) stake especially as NIC and NPF are both public sector and portfolio (not operational nor takeover) investors.

5. For NPF and NIC-Life to find equity attractive the following guidelines would need to be met:
- a. initial price per share about 10 times projected dividend to be paid in year of purchase;
  - b. controlling shareholder agreed with NIC/NPF to back them in policy of payout of at least 50% of post tax profits in dividends;
  - c. reasonable profit projections suggested rise of 3 to 5% in real (that plus inflation in nominal) profits and dividends.

e.g.

	<u>Inflation</u>	<u>Dividend/Return</u>
Year 1	20%	10 (%)
Year 2	20%	12.5 (%)
Year 3	15%	15.5 (%)
Year 4	10%	19 (%)
Year 5	10%	21.4 (%)
Year 6	10%	24 (%)

On that basis from Year 3 (on this example) the dividend yield is above the rate of inflation and rising (especially if inflation is falling) so is superior for pensioners/policy holders to an investment in government stock.

6. There is not an extensive list of companies meeting these tests but TCC (cigarettes) and TBC (brewing) do as perhaps does TPDC. Over time the number suitable should rise.

#### A Unit Trust?

7. Once a substantial number of shares in at least 20 enterprises were available, a unit trust (managed by TDFL or proposed Merchant Bank) could be launched. As it would channel private savings into private or mixed firms without affecting control no ideological or strategic control issue should arise. (IPS might launch a private sector one if there were enough stable, relatively high dividend private enterprise shares.)

8. For this purpose a tougher price/dividend ratio should be charged - say 15:1. The manager would initially sell units at this price plus one and one-half per cent (or 2%) and buy back at this price minus one and one-half per cent (or 2%). The 3% (4%) spread would cover the manager's costs. This is a managed market approach which would be satisfactory in optimistic context (by investors) as then the Unit Trust would buy more shares to issue more units. It would be problematic in a pessimistic context as the management would find itself investing in units it bought back for which there were no bidders when it turned to sell them.
9. How serious that would be really depends on how long the pessimism endured and how many units were sold in to manager. Unless dividends collapsed the initial return to holder would be 6.6 7% rising annually. That is not an impossible position unless sums are very large relative to TDFL or MB equity. In that case there would be a need to raise an interim loan (from Hazina?) at rate of interest equal to dividend yield (thus rising over time) and of a duration lasting until units resold.

And Then?

10. After 5 years of successful unit trust operation, a stock market could be envisaged - with the unit trust one of listed securities. If the market is to be liquid and to avoid wild swings some enterprises (TDFL? MB? Both?) will need to act as merchant (with a portfolio to sell from or buy for) as well as broker.
11. The implicit time schedule is:
- a. NPF/NIC authority to buy equity - 1-VII-90;
  - b. Initial equity sales to NPF/NIC - 1-VII-90/30-VI-91;
  - c. Unit Trust Study - 1995/96
  - d. Unit Trust Floated - 1996/97

e. Stock Market Study - 2000/01

f. Depending on "e"

Stock Market Opened - 2001/02



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31-I-90



EFFICIENCY, SERVICE, COMPETITION, MULTIPLE FINANCIAL  
INSTITUTIONS: To What Ends? For Whom?

By R. H. Green

Ends or Means?

1. Efficiency is fairly clearly seen as an end but unless one specifies efficiency for whom and at what, it is none at all clear what the end (ends) is (are). In the case of financial institutions in Tanzania greater efficiency is usually related to speed and accuracy of transaction completion, reduction in costs (to user or to institution) and lowering of proportion of bad loans extended. Customers and their clients would be the chief direct beneficiaries but Hazina/BOT would also benefit significantly from more timeous, accurate data leading (one hopes) to better policy analysis. That plus quicker, more accurate financial services should have a positive macroeconomic impact. Service (to customers and to data users) is a goal or end set which largely overlaps efficiency. Competition is a means to achieving certain gains in efficiency and service - albeit it can also increase cost and lower the range and quality of service. Multiple financial institutions are a means (not the only one) to encourage competition.
2. It seems appropriate therefore to look first at efficiency - speed, accuracy and cost of transactions followed by an examination of service, i.e. efficiency of what is on offer to customers and what reasonably expected services are not on offer. Competition would then be viewed in terms of its potential contribution (positive or negative) to efficiency/service and multiple financial institutions as one means to competition.

Efficiency

3. Transactions are made and brought to account too slowly;
  - a. there is not enough decentralisation;
  - b. equipment is inadequate (it has aged since mid-70s and transactions have increased in numbers);
  - c. analysts and decision takers have a tendency to dither rather than decide promptly even when this hinders the borrower and raises (not lowers) risk;
  - d. NIC's agents either share these weaknesses or have own reasons for delaying remittances to NIC.
4. The evident ways forward are:
  - a. decentralisation especially of mass of smaller transactions to reduce load at Zonal/HQ levels;
  - b. installation of adequate, speedy data recording-processing-transmission system. (Not per se high tech. The smaller branches could use Burroughs accounting machines - sub PC - if they had functioning ones.) The ability to get data in to Zone/HQ and back to other branches seems to be almost a worse bottleneck than recording them.
  - c. Retraining.
  - d. Tighter rules and more severe penalties (loss of part of commission, replacement by new agent).
5. Errors in recording and failure to clear up promptly are endemic - apparently most in NBC and NIC. This seems to relate back to slow recording and weak checking both related to:
  - a. recording and transmitting equipment;

- b. staff training;
  - c. lack of adequate priority to reconciliation plus digging away at backlog while new errors pile up.
6. The ways forward are fairly evident once problems are stated.
  7. How high costs per transaction are is not very clear nor is it at all self-evident they are rising in real terms. (Interest expense is not a cost relevant to this exercise.) IFM (backed if needed by a Treasury procured CFTC consultant from - say - Malaysia or Jamaica) should do an independent transaction cost level and (real) trend and identify areas for saving. Slow recoding-transmitting-reconciling and extra time costs of non or late reconciliation are cost raising. Apart from better training and supervision (including against theft or collusion therein) cures beyond better equipment are not self-evident in advance of such a study.

### Services

8. Most complaints on service (other than wanting cheap credit on demand!) relate to lack of speed, presence of errors.
9. The other large meetable category seems to turn on access:
  - a. distance to unit of FI in question;
  - b. powers of nearest branch;
  - c. hours of opening.
10. NBC - if it has now restored rural mobile agencies - has about the best coverage of any FI in SSA. Other FI's have less branches but cannot (except perhaps marginally NIC) justify more on economic grounds nor even on social benefits. But cross use of each other's branches as agents should again be explored, e.g. NBC could receive (and check for correct filling in) TRDB, NIC, THB applications (and stock forms for them) in branches/agencies/mobile agencies where the other FI had no nearby branch.

11. Decentralisation and speed of decisions at higher level (and communication of and action on them by branches) could make access to a branch more useful. This is especially true re decentralisation for NBC but TRDB and TIB could probably decentralise more to zonal level.
12. NBC branches should be free to set own hours subject to at least one branch open 8.00 to 3.00 Monday/Friday and 8.00 to 1.00 Saturday in each town with a branch, and to 40 hours per normal week per branch. Varied hours should be encouraged, e.g. 8.00 to 10.00 and 12.30 to 5.00 Monday to Friday plus 10.00 to 2.30 Saturday. Other FI's should seek to have at least some hours of opening which are usable for enterprise and government employees, e.g. 8.00 to 9.00, 12.30 to 2.00 for enterprise and 2.30 to 5.00 for government (perhaps plus Saturday afternoon experiment?).
13. What new services are needed/feasible is unclear. For instance, multiple borrowing, deposit, insurance forms do exist in Europe-NA-Japan, etc., but most are either, a.) tax avoidance; b.) product differentiation, or c.) special market, e.g. the infinite set of mixes of term life insurance plus endowment or deferred annuity policies in UK relating to a/b/c. It is not clear how many would make sense in Tanzania. Indeed one has the impression a number of services, e.g. NBC Travellers Cheques, PTA Travellers Cheques, some Life and Pension policies are very little used even though they relate to genuine (but perhaps small minority?) needs.

#### Competition

14. Financial institution competition does lead to a greater range of opening hours and of services and to more branches. In general these raise costs and have a quite uncertain effect on decentralisation.
15. Where equipment and training are bottlenecks, if competition is in a form requiring more equipment and personnel, it will tend to slow increases in efficiency.

AnnexFinancial Institution Shareholding

1. A case exists for more than one shareholder in financial institutions. Because of their key role in macro economic policy operation a 51% Treasury shareholding would seem appropriate but the other 49% could be held among:
  - a. the BOT
  - b. other financial institutions
  - c. NPF/NIC-Life Fund
  - d. a unit trust if created.
  
2. The BOT has a key role in monitoring and regulating FI's. Whether this precludes or argues for shareholding is not self-evident. The Treasury also has a monitoring/regulating role (and is the source of some of the powers exercised by the BOT) and is the dominant (indeed sole) shareholder. Minority shareholdings and Board seats could help build up day to day, non-confrontational, pre-crisis (hopefully crisis averting) contacts. (This has often been true of Treasury-FI relations). 20 to 25% BOT shareholding exists. If this reshuffle is done, BOT should purchase the shares from the Treasury at book value paying by retirement of mature or near mature long term Treasury Stock. This would have the useful side effect of reducing Government borrowing from the banking system.
  
3. Crossholdings are a not unusual way of reinforcing business relations. The following pattern might make sense:
  - a. NBC - 15% TIB  
15% TRDB  
15% THB  
15% NIC
  - b. TIB - 10% NBC  
10% TRDB
  - c. TRDB - 10% NBC  
10% TIB
  - d. NIC - 5% NBC  
5% TIB  
5% TRDB  
10% THB

The shares could be purchased from Treasury either by payment in Treasury Paper (notes or stock) held by the FI's or by issuing additional equity to Treasury. Transactions at book value. If paid for in Treasury paper, the NBC purchases (but not the others) would reduce government borrowing from the banking system.

4. NPF/NIC-Life holdings should be deferred until the post financial reconstruction dividend capacity of the FI's is clearer. The same pertains to a Unit Trust if one were to be created soon.
5. This suggests the following structure:

<u>Holder of</u>	<u>NBC</u>	<u>TIB</u>	<u>TRDB</u>	<u>THB</u>	<u>NIC</u>
Treasury	51	51	51 (51)	51	55
BOT	24	19	19 (14)	24	25
NBC	-	15	15 (10)	15	15
TIB	10	-	10 (5)	-	-
TRDB	10	10	- (-)	-	-
THB	-	-	- (-)	-	5
NIC	5	5	5 (-)	10	-
Co-ops	-	-	- (20)	-	-

\* THB has a more doubtful basic business than other FI's at least until interest rates fall by 50% or more. Thus it cannot afford large chunks of potentially low return assets swapped for higher yield Treasury paper. However, its cross-links with NIC are crucial so it should make that investment - especially as NIC should be well able to pay 10% (on equity plus retained earnings) dividends.

6. Merchant Bank shareholding is discussed in a separate memo. Like TDFL it is seen as a second tier FI owned by others (and an outside shareholder in MB case) not direct by Treasury.
7. Crossholdings with Co-Bank might make sense once it is decided what useful role, if any, Co-bank can play. Alternatively Co-bank could be merged into TRDB and Co-ops take 20% shareholding in TRDB/CB merged FI.

## INTEREST RATES - MEDIUM AND LONG TERM

By R. H. Green

Overview

1. Short term rates have been discussed in Credit Allocation memorandum. Issue of 10% devaluation uplift on foreign exchange loans also discussed in memo covering Devaluation Losses.
2. Broadly short term rates of 25% falling as inflation does so that they stay in the -2% to +2% real range (now perhaps near -2% and could gradually be pushed to +2% as inflation and nominal interest rates fall) are satisfactory.
3. Long term (fixed capital finance) rates are more problematic.
4. The maximum nominal rate likely to be viable is 25% (unless extreme inflationary psychology develops which is undesirable). Even that is viable only if it:
  - a. includes devaluation premium when on lent funds are of foreign origin, i.e. TIB or Hazina 15% interest + 10% devaluation insurance premium = 25%
  - b. is floating rate, i.e. if inflation falls (hopefully when) long term loan rate on existing loans is also reduced.

Basic Approach

5. TIB, TDFL and Hazina (on bulk of loans to parastatals) can charge:
  - a. Average of past 2 calendar years' national COL inflation (only usable index available) plus 2% subject to a maximum of 25%;

b. A devaluation insurance premium of up to 10% (see relevant memo) but ceiling of interest and premium to be 25%.

e.g.	1988 (Calendar Year)	26%	COL Rise
	1989 ( " " )	<u>24%</u>	" "
	Avg.	<u>25%</u>	
	Calculation	25% + 2% = 27%	
		25% <u>Ceiling Rate</u> as of <u>1-VII-90</u>	
e.g.	1990	20%	COL Rise
	1991	<u>18%</u>	" "
	Avg.	<u>19%</u>	
	Calculation	19% + 2% = 21%	
		21% as of <u>1-VII-92</u>	

6. These rates should be OK in sense of not blocking manufacturing, construction (i.e. contractors), transport (i.e. road haulage), mining and most capital intensive service industry fixed investment. They are high enough to create incentive to use capital efficiently and to finish projects fast (unlike New Africa Stage III whose 1972-1990 and still counting gestation is a model of what never to do. Almost certainly should have been completed before or instead of rehabilitating Kili which was functioning and which is a basically structurally unsound building.)
7. Para 6 holds only if floating rate so inflation fall does not crush the enterprise with very high real interest rate. Historically real interest rates over 5% have been incompatible with sustained market (free or managed) economy growth. In 1980s high real interest rates appear to have deterred investment (and not raised savings) in several industrial economies (e.g. USA). But floating rate is perfectly simple and standard device now so TIB, TDFL, Hazina could use it quite easily.
8. As noted in Devaluation Loss/Risk and Parastatal Finance from Government memos if enterprise finance from foreign sources is soft (grant or 1%/40 year) to Tanzania and lent at - say - 15% + 10% devaluation insurance = 25% then:
- a. Hazina or Financial Institutions can break even after devaluation unless inflation (and thus devaluation) explodes up;



- b. the total 25% level is (just) plausible from efficiency in investment perspective (i.e. at high end but not impossible).
9. On domestic funds 25% (now) on loans and lower deposit (or Treasury) borrowing rates allow a significant profit margin.

TRDB

10. TRDB faces two problems:
- a. appropriate interest rate and repayment conditions on short term (circulating capital for inputs) producer loans;
  - b. ditto for long term (fixed capital) producer loans;
11. "10-a" (short term) is discussed in Credit Allocation memo.  
Basically:
- a. an insurance premium
  - b. interest cut by 50% or to 10% (whichever is lower) and principal roll-over in bad and
  - c. interest waiver and principal conversion to loan payable over next four years in terrible crop year

are ways forward. But any workable (to borrowers) premium will entail lower margins (or absolute losses) to lender, i.e. a subsidy at least until interest rates fall to 6 to 8% nominal (4 to 6% inflation). Further, objective identification of 'bad' and 'terrible' year results poses problems - individual and local results do not usually mirror national averages very well. However, TRDB should commission a study, e.g. IFM-Sokione University to see what might be practicable. This is especially true as de facto TRDB does not (cannot) collect interest and principal from weather hit producers and, not budgeting for this predictable problem, has 'unexpected losses' and 'non-performing loans' ad hoc instead.

12. The long term problem is analogous to the short. "What if first 2 or 3 years have weather blasted - or washed out - results?" At 25% interest the initial losses and delayed payments will wreck finances even if over 5 to 10 years the average output and operating surplus is on target. There may be a feasible way forward. The illustration is for 10 year loans (10 years from date of operation - see below for pre-operation period) but could be altered for 5 or 20 quite easily:

a. Principal Repayment

. Years 1 and 2	Grace
. Year 3	Deferrable by Mutual Consent
. Years 4 through 10	14.3% if 12.5% paid in Year 3/Otherwise 14.3%

b. Interest

. Years 1 and 2	Standard Rate but " <u>if earned</u> "
. Years 3 through 10	Standard Rate plus 2% premium (for risk to lender on "if earned")

13. The above is not a cure but it would allow non-disaster cases to ride out 1 to 3 early bad harvest years and would not impose intolerable strains on TRDB cash flow.

Housing Bank

14. Owner occupied residential housing is not viable at 25% nominal interest rates. An example will make clear why:

Minimum L. Wage Earning Household

<u>Income</u>	Wages TSh	16,000	
	Other	<u>12,000</u>	28,000
<u>House Cost</u>	(Swahili style - small)		120,000
. Interest at 25%			30,000

Interest exceeds probable total household income and is about double minimum wage.

15. THB cannot lend for owner occupied houses if appropriate interest rate is over say 8%. (At 8% interest plus 20 years to repay above example would yield TSh 10,800 or 38.6% of income as pre-maintenance

housing cost which is very high.) In practice conditions for safe (to THB or borrower) lending to would-be owner/occupiers are:

- a. 50% increase in real wages (relative to house cost); and
  - b. 6 to 9% nominal interest rates. Which is implausible over next few years - at least out of funds raised from term deposits or normal interest Hazina loan capital.
16. Thus THB can for now and probably to 1995 conduct normal operations at normal interest rates (i.e. 25% now/floating) only for:
- a. commercial-factory-godown premises
  - b. houses/flats built to be rented to upper middle-upper income groups.
17. "16-a" may be a priority. At any rate THB should engage in it on at least a modest scale to keep the institution in being on a viable basis.
18. "16-b" is not a priority. Low income housing cannot be built that way. At 25% interest, rents will need to be 35% to 45% of initial cost of construction or TSh 42,000-54,000 on the example Minimum Wage household house! Upper income may as well be required to use tontines or the parallel (bazaar) market. The point is not to ban it but also not to channel limited formal institution long term capital to it.
19. If the "Workers and Peasants Housing Development Fund" and Levy still exist, a modest owner-occupied programme can be run by THB out of those funds:
- . Loans to workers - housing co-ops (urban) and village analogous to housing co-ops;
  - . Years grace plus 10 to pay on principal;

- . 5% interest
- . Maximum loan 1990 prices (adjustment each July 1 by same % as minimum wage increase) TSh 75,000 per housing unit;
- . Maximum % estimated cost of unit covered 80%;
- . Preference to:
  - i. deposit account (with THB) holders;
  - ii. material only loans (i.e. below 80% of total cost);
- . Check-off system for collection.

20. The minimum wage household, e.g. looks less implausible here:

a. Income TSh 28,000

b. House Cost by "Fundi Team"	-	80,000
-20% owner 'equity'		<u>16,000</u>
Loan		<u>64,000</u>

c. Years 1 to 4 (interest only)                    3,200  
(about 11 and one-half per cent of income in Year 1)

By Year 5 inflation and (hopefully) real minimum wage rises will have made added TSh 6,400 bearable.

#### Interest During Construction

21. Interest from loan drawing to start of operations is normally capitalised. The problem is how to finance it on a cash flow basis - and how to minimise it by quick project completion.

22. A mix of sources might be suitable:

a. 50% equity

b. 50% development finance unit loan up to agreed start-up date.

e.g. Total Loan TSh 100 m.

	<u>Avg. Balance</u>	<u>Interest (at 25%)</u>
Year - 2	16 m. (end 30 m)	4 m
Year - 1	44 m. (end 60 m)	12 m
Year - 0	76 m. (end 100 m)	19 m

(Year 1 in commercial operation)

Total Interest	- 34 m
Equity	- 17 m
In Loan	- 17 m
(Construction Cost	- 83 m)
(Total Loan	- 100 m)

23. This approach helps handle cash flow problem and focuses lender and attention on interest during construction as a major, problematic, cost element. Also by halting lending for interest when agreed (borrower/lender at time of loan agreement) entry into operation date passes; it focuses borrower attention on getting project completed and running on time.

24. The analogue to this on borrower side is draconic penalties for failure to deliver or to complete on time in its contracts with suppliers, contractors and action to enforce those damages plus a 20% of purchase/contract price payment due only on successful completion and against which penalties may be charged. (The Government as well as parastatals and private enterprises should use this penalty clause and enforcement backed by large completion payment to reduce late delivery. So long as there is no real penalty for late delivery it pays a contractor to take on more business than he can handle on time - but if he will lose up to 20% of price by such tactics he won't try that trick.)