

EAGER

Policy Brief

NUMBER 56 / FEBRUARY 2001

Constraints to Capital Market Development and Growth in Sub-Saharan Africa: The Case of Tanzania

1. Introduction

In the 1980s and 1990s many countries in Sub-Saharan Africa (SSA) embarked on financial sector reforms that featured structural adjustment programs targeting their financial system in order to enhance savings mobilization and credit allocation to the private sector for growth and poverty alleviation. However, a decade after the reforms, critics argue that the reforms have had little impact on capital markets, failing to remove many of the constraints that militate against the development of a functioning capital market.

The objective of this study is to examine the various problems that constrain the development of functioning capital markets in SSA in general and Tanzania in particular. The study also examines the impact of the government's recent policy changes on capital market development and the operations of non-banking financial institutions that intermediate the capital markets. The study analyzed the link between capital market development indices and the real sector growth in Tanzania. The issues of capital market regional integration and globalization are also examined with regard to the policy implications. The study also addresses the impact of policy changes on equity and poverty alleviation in Tanzania.

The study conducted field surveys by administering survey questionnaires to various financial and regulatory institutions, the Dar es Salaam Stock Exchange (DSE), and the Bank of Tanzania (BOT). Additionally, secondary data was collected to supplement primary data. Parametric statistical analysis was also adopted in testing various hypotheses derived from this study's policy research questions.

2. Findings of the study

This study finds that the policy changes in Tanzania have positively impacted and challenged capital market development. The passage of various regulatory



*Equity And Growth through Economic Research—
an activity of USAID, Bureau for Africa, Office
of Sustainable Development, Strategic Analysis Division*



laws and reforms such as the Foreign Exchange Act of 1992, the Capital Markets and Securities Act of 1994, the Insurance Act of 1996, and other relevant reform laws have provided strong legal foundations for efficient capital market development in Tanzania.

The liberalization of interest rates and the removal of regulations on financial institutions resulted in more players in the capital market. The emergence of various financial and capital market institutions has enhanced the market's capacity for competition. The establishment of the Capital Market and Security Authority (CMSA) was also an integral part in promoting an active capital market development in Tanzania.

The establishment of the Dar es Salaam Stock Exchange (DSE) in 1998 marked an important milestone in the effort to develop a functioning capital market for the mobilization and allocation of long-term capital to the private sector. During the short time of its establishment, four companies have been listed on the DSE as of December 1999. Three of these companies have raised a combined equity capital of TShs 28.57 billions (an equivalent of US\$35.71 million) in the primary capital market. The fourth company, East African Development Bank, has raised an amount of TShs 10 billion (an equivalent of US\$12.5 million) through the issue of a four-year corporate bond.

In terms of financial resource mobilization through the banking system, the study shows that aggregate savings which was on the decline before the reform, had increased during the reform

period. However, contrary to expectations, the policy changes have not been accompanied by increases in credit allocation to the private sector. The study also found that the introduction of high-yield government short-term Treasury bills has increased the demand for Treasury bills at the expense of investment in the stock market. As a result, commercial banks tend to switch a greater proportion of their deposit liabilities into Treasury bills. This portfolio switching by the banks tends to crowd out the private sector and productive activities from the capital market.

This study shows that regional integration and globalization of the Tanzanian capital market would be beneficial in terms of attracting foreign capital, efficiency of utilization of capital, and corporate governance. Foreign participation would also encourage domestic participation in the capital markets.

The study also shows that the CMSA has been effective in promoting good corporate governance in Tanzania. Disclosure requirements are specified and monitored by CMSA and DSE. The share price movement has been an effective way of demanding accountability from listed companies. The price movement at the DSE has also shown how the operations of a free market mechanism lead to efficient pricing of financial assets in the stock market.

3. Remaining problems and challenges

The study finds that even though the policy changes in Tanzania have had

some positive impact on capital market development, there are many challenges and problems that remain to be addressed in order to promote a functioning capital market in Tanzania.

The enactment of banking and financial institutions' reforms were supposed to strengthen the capital market institutions in order to mobilize financial resources for allocation to the private sector. However, the slow restructuring of the collapsed banking sector resulted in the decline of credit to the private sector, especially the productive sectors of the economy, including agriculture and marketing of agricultural products. The direct impact of this result is the reduction in growth potential and poverty alleviation in Tanzania.

There is inadequate competition within the financial sector. Such evidence includes the large spread between deposit and lending rates, which has, on average, been above 15% throughout the post-reform period. This suggests that financial prices do not adequately reflect market conditions and the cost of funds. An inappropriate interest rate structure is obviously likely to affect both stock prices and exchange rates, and thereby affect the capital market generally.

The capital market still remains underdeveloped. The problems of illiquidity, infrequent trading, and fewer listings of private companies limit the attractiveness of the capital market to domestic and foreign investors. The lack of absorption capacity and low demand for equity securities has been worsened by the lack of government incentives to

attract new companies and investors to the stock market.

The infancy of the capital market structure is reflected in the fact that the DSE has only recently been established and currently has four companies listed on the exchange. This signifies that the instruments for resource mobilization in the capital market are still few and in the process of formation.

The government's fiscal policies of taxing dividends on equity securities while exempting interest income on short-term Treasury bills provide greater incentives for investing in government short-term securities at the expense of investment in long-term equity securities. In addition, the general weakness of Tanzanian currency and creeping inflation provides disincentives for investing in the capital market for long-term benefits.

One of the basic goals of reform has been to ensure a greater allocation of credit to the private sector for growth and poverty alleviation. However, our survey results show that the greatest problem facing the private sector is the access to credit, especially long-term capital for productive activities. The collapse of the banking sector in Tanzania due to large non-performing loans led to reduction of credit to the private sector. Furthermore, the banks' preference for short-term overdraft loans to corporate entities makes it difficult for even creditworthy corporations to raise long-term capital for productive enterprises.

The new regulation of high bank reserves also limits the ability of commercial banks to make long-term

loans to the private sector. In addition, the requirement of tangible collateral also inhibits small enterprises from raising capital in the capital market.

The study also finds that the capital market structures in their present form are not suitable for small and medium enterprises to raise capital in the form of equity securities. Unlike the US, where capital market structures are developed for small and medium-sized firms to raise capital in the Over-the-counter (OTC-NASDAQ) markets, there are no such second tier markets in Tanzania to attract small firms that cannot be listed on the DSE.

Also, the complementarity of capital and money markets in providing long-term and working capital to the private sector is hampered by the banking sector's lack of responsiveness to credit needs of the private sector.

The lack of foreign participation in the capital market is detrimental to the development of the capital market. Additionally, the lack of development of capital market instruments, such as venture capital and institutions, investment banks, corporate bonds, mutual funds, and unit trusts, derivative securities, and options, limit the stock market's attractiveness to investors. The lack of financial derivatives and options precludes risk management by hedging underlying stocks in the futures and options markets.

Even though regional integration and globalization of the capital market in Tanzania has beneficial implications for the domestic economy, it has its risks as well. Capital market globalization bears the risk of domestic price fluctuations,

which may be the result of macro-economic instability in the domestic economy. This is a clear lesson from the Southeast Asian countries' financial crisis.

The study also finds that the unintended consequences of slow growth and low per capita income of the general population have policy implications for equity and poverty alleviation in SSA in general and Tanzania in particular.

In view of the complexities of the developmental problems in Tanzania and other SSA countries, it is our opinion that policy recommendations should be formulated to satisfy short- medium- and long-term goals and objectives. However, the sequencing of policy recommendation implementation may be at the discretion of the policy makers. With this in mind, we offer the following policy recommendations designed to address some of the problems and challenges facing the capital market in Tanzania.

4. Policy recommendations

The government's effort to tackle inflationary pressures by introducing cash budgeting has helped control inflation. However, recent developments in energy prices and market speculation have led to deterioration of the Tanzania Shilling's value. An effective monetary policy, coordinated by a prudent fiscal budget balance, will provide the stable macroeconomic environment necessary for capital market development.

The adoption of prudent fiscal and monetary policies is essential to maintaining internal and external stability, to minimizing the negative

consequences of foreign shocks on the domestic economy, and thus, to preventing financial outflows from the domestic capital market.

The government should provide fiscal incentives like tax exemptions for new private firms that desire to be listed on the stock exchange. This policy has been introduced in Botswana and other countries with positive results. The equal treatment of dividends on equity securities and interest income on Treasury bills (for tax purposes) will provide a level playing field for investors in equity and short-term money market financial instruments.

The introduction of various capital market products such as mutual funds, unit trusts, government, and corporate bonds will increase prospects for portfolio diversification and thereby enhance the attractiveness of the stock exchange and bond markets in Tanzania. These collective investment instruments will also attract small investors who may not be able to invest in individual stocks that require greater income, sophistication, and risk concentration.

As our survey results show, it is important to intensify publicity of the long-term benefits of the stock and bond markets through public education media such as television advertisements, radio, print media, and pamphlets.

Harmonizing accounting practices and the transparency of information disclosures is essential for price discovery and efficient portfolio management. Additionally, reduction of transaction costs associated with improvements in clearing and settle-

ments will increase the efficiency of stock exchange trading. The effort to create automated central clearing and settlement should be expedited to enhance the efficiency of such mechanisms. The computerization of the stock exchange is therefore necessary to increase the frequency of trading. This will increase liquidity, marketability, and the overall attractiveness of stock exchange trading. Additionally, the establishment of an over-the-counter (OTC) stock exchange for small enterprises will encourage small and medium-sized firms to list on the stock market.

The government should be encouraged to undertake privatization of viable state-owned enterprises (SOEs) through the stock exchange rather than privatizing through strategic investor channels.

The innovative plan to provide employees stock ownership (ESOP) of privatized government-owned enterprises will increase the ownership pool of privatized companies. This may also reduce the tension surrounding the privatization of the SOEs and thereby alleviate the apprehension of employees who are fearful of losing their employment through such privatization.

The government's practice of raising funds in the short-term market by auctioning short-term securities in the money market exerts much pressure on short-term interest rates. Synchronizing of government sources and uses of funds in terms of issuing long-term bonds to finance long-term projects will provide stable short-term and long-term yield curves. In addition, government debt issued through the stock exchange has the

potential to deepen the capital market. It also has the potential to increase the liquidity and turnover of the stock exchange.

Excluding foreign participation in the stock exchange contributes to low liquidity and low turnover in the stock exchange. We recommend changing the current policy to permit foreign participation in the domestic capital market, thus attracting foreign capital to the domestic capital markets.

With regard to regionalization and globalization of the domestic capital markets, it is necessary to harmonize macroeconomic conditions as well as the legal and regulatory framework according to regional and international standards. Additionally, it is necessary to improve the domestic capital market in order to build internal domestic capacity to absorb cross-border trades. It is also necessary to harmonize trading rules and practices of the domestic capital market with neighboring markets. The adoption of international accounting standards and transparency of information disclosures will be essential to ensure regional co-operation among member countries.

The role of capital market development in promoting economic growth is confirmed by this study. Moreover, the negative consequences of reducing credit to the private sector and its subsequent negative impact on poverty alleviation is confirmed. It is therefore important to develop strategies and programs that ensure long-term credit access for small and medium-sized enterprises that experience difficulty

raising capital in a post-reform era. The establishment of small business development centers and guaranteed business and project loans will enhance small business prospects of obtaining loans for productive activities in the economy.

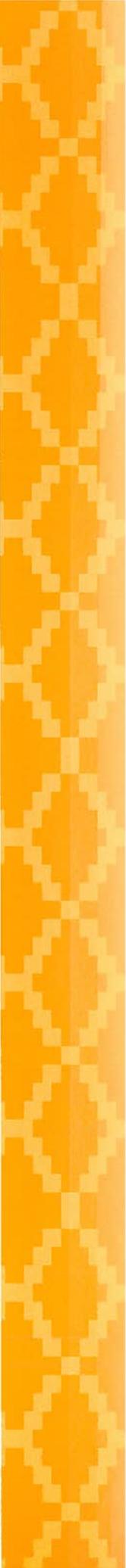
The role of non-governmental organizations (NGOs) in providing financial services to the poor, especially those in the rural areas, should be encouraged. Thus, the re-allocation of many of the NGOs from the urban areas to the rural areas should also be encouraged.

In order to ensure fairness and equity of the public's credit access, it is necessary to establish various Consumer Bills of Rights as initiated in the US. This will protect the public from unfair banking sector practices such as extending credit to the private sector. The enactment of the Equal Credit Opportunity Act, as an example, will exert pressure on financial institutions to adopt uniform and transparent standards for screening loan applications for business enterprise credit extension.

This policy brief is based on EAGER Discussion Paper Number 79, *Capital Market Development and Growth in Sub-Saharan Africa: The Case of Tanzania*, 2001, by Sam Ziorklui [sziorklui@aol.com], Howard University, Washington, D.C., in collaboration with Lemma W. Senbet [lisenbet@rhsmith.umd.edu], University of Maryland, Abdiel G. Abayo [CapMarkets@Cats-net.com], Capital Market and Securities Authority, Flora Musonda [fmusonda@esrf.or.tz], Economic and Social Research Foundation, Bartholomew Nyagetera and Longinus Rutasitara, University of Dar es Salaam and Gabriel D. Kitua [bankingraha.com], Bank of Tanzania.

The views and interpretations in this policy brief are those of the authors and not necessarily of the affiliated institutions.

EAGER Policy Brief



To Order Policy Briefs or Other EAGER Publications

EAGER Publications/BHM

P.O. Box 3415

Alexandria, Virginia 22302

tel/fax: 703-299-0650/703-299-0651

email: spriddy@eagerproject.com

**All EAGER Publications can be downloaded
from www.eagerproject.com**