Tanzania Investment and Consultant Group Ltd

The Financial Markets and Innovation in Productivity of Economy in Tanzania

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ABSTRACT

The extended period of limited growth experienced until recently in many African countries raises the issue as to which policies could be most effective in improving their economic performance. This study argues that further financial sector reforms may be a valuable complement to ongoing efforts to reform labour and product markets. There is a long-standing view in the economic literature that well-functioning financial systems allow economies to exploit the benefits of innovation in terms of productivity and growth. Moreover, measured productivity differentials between Africa countries seem to originate particularly in the financial sector and from sectors that are particularly dependent on external financing.

The results suggest that there are a number of ways in which the financial market conditions in African be improved to increase the contribution of the financial system to innovation, productivity and Economy growth. The most robust conclusions can be drawn for certain aspects of corporate governance, the efficiency of legal systems in resolving conflicts in financial transactions and some structural features of Africa bank sectors. For example, econometric estimations indicate that improving these conditions is likely to increase the size of capital markets – a summary measure of overall financial development – and thereby enhance the speed with which the financial system helps to reallocate capital from declining sectors to sectors with good growth potentials.

EXECUTIVE SUMMARY

The extended period of relatively slow growth and high unemployment experienced until recently in many Africa countries has led to increased efforts to identify policies that could improve economic performance. The reasons for the structural economic weakness are manifold, and the Agenda need for a multi-sector approach. This study focuses on the financial sector and, in particular, on potential ways of improving its functioning and contribution to productivity, innovation and Economic growth in Tanzania.

CONCEPTS AND METHODOLOGY

The efficiency of a financial system, that is the set of intermediaries, markets and infrastructures through which households, corporations and governments obtain funding for their activities and invest their savings, is positively influenced by financial development. Financial development (which, for industrial countries, is perhaps better described as financial modernisation) refers to the process of financial innovation as well as institutional and organisational improvements in a financial system that reduce asymmetric information, increase the completeness of markets, add possibilities for agents to engage in financial transactions through (explicit or implicit) contracts, reduce transaction costs and increase competition.

Financial integration and financial development are distinct, but interrelated. On the one hand, financial integration and financial development are mutually reinforcing in improving the performance of a financial system. Integration, for example, fosters development by enhancing competitive pressures and offering new financing and investment opportunities, while development contributes to integration as new financial instruments may facilitate the trading of risks. On the other hand, progress in financial development can also be achieved independently of financial integration and vice-versa.

MAIN RESULTS

The main results of the paper are those that are supported by all elements of the analysis presented, namely: 1) the empirical and theoretical results of the existing literature; 2) the implications drawn from relevant indicators; and 3) the results of the econometric analysis. For example, the literature and own econometric analysis may suggest which financial variables drive productivity and growth in industrial countries in general. The indicators may then show for which dimensions of a financial system Tanzania capital markets or the capital markets of specific Africa countries under- perform. If all the elements point in the same direction, then it seems worthwhile considering whether any problems in the Tanzania financial system can be addressed with policy.

Overall, the main results suggest that there is significant room for further modernisation and development of Tanzania financial markets. A first finding is that, in terms of their size, euro area capital markets have considerable potential for further growth. Their (relative) size is roughly comparable to Japan, but much smaller than the Netherlands, the United Kingdom, Switzerland or the United States. Moreover, the econometric estimations suggest that overall capital market size (defined as the aggregate of bank, corporate bond and stock market financing as a share of GDP) is the main financial determinant of the speed of capital reallocation. Other economic variables or specific aspects of financial development/modernisation play much lesser roles. Hence capital market size constitutes a useful summary measure for gauging the overall financial development of industrial countries.

More specifically, the analysis identifies three areas where the financial market framework conditions in Tanzania could be improved:

① A. The first concerns certain aspects of corporate governance. TICGL strongly suggests that minority shareholder rights are an important aspect of well- functioning securities markets. Better governance ensures that: 1) there are fewer conflicts of interest among investors, as well as between investors and managers;

② investors obtain a better return; and

③ there will be a smaller loss of efficiency due to opportunistic behaviour by managers. While general shareholder rights for publicly traded firms have significantly improved over time in Tanzania , it is still quite difficult for minority shareholders to enforce protection against self-dealing by controlling shareholders or company directors of public firms.

In conclusion, it may be advisable to remove obstacles preventing efficient legal action by minority shareholders against self-dealing by corporate insiders.

B. The second area is the efficiency of the legal system in resolving financial conflicts. TICGL emphasises the great importance of efficient legal systems for the well-functioning of financial systems, since the inter-temporal nature of financial contracts and the large values contracted upon require a high degree of confidence in their enforcement. Slow and formalist legal systems, i.e. systems with many formal steps that regulate legal disputes, discourage savers and investors from entering financial markets, as they face greater expropriation risk, thereby limiting the supply of capital and the liquidity of markets. A widely used indicator of the speed with which legal systems solve financial conflicts suggests that legal efficiency could be enhanced in a small number of Tanzania. The econometric analysis confirms that the fast resolution of financial conflicts by a legal system has a positive effect on capital market development and thus improves the reallocation of capital in an economy.

C. The third area relates to the structural features of Tanzania bank sectors. In recent decades most banking systems in industrial countries have been liberalised extensively, but a small number of Africa countries still have relatively significant levels of public bank ownership. A substantial strand of the academic argues that public bank ownership can have a distortionary effect. For example, publicly owned or controlled banks have been found to pursue political objectives. They may also adversely affect competition, for example by constraining domestic and foreign entry.

Furthermore, the econometric analysis presented in this study indicate that larger ownership of banks by the public sector may be associated with smaller and less developed capital markets, which in turn hampers the reallocation of capital. The countries that still have significant shares of bank ownership by the public sector should consider whether their banks perform better than the average recorded in the literature for banks owned by the public sector.

Moreover, the analysis also singles out Tanzania risk capital markets as an important part of the financial system to improve. For the two main areas of risk capital markets identified, however, there is insufficient information available at present to derive strong conclusions for policy. While it is possible to make the following points, both these areas would benefit from further research.

A. Start-ups and other small innovative firms are an important source of economic value- added and growth. However, the financing of their investment projects is particularly difficult. They have no access to public capital markets and may have difficulties obtaining private bank financing due to asymmetric information e.g. related to the absence of a track record, high risk and little collateral. Significant private equity and venture capital markets help to overcome these difficulties in modern financial systems. The indicators show that venture capital financing in the Tanzania is much lower than that observed. This is particularly visible in early-stage financing but holds also for expansion and replacement-stage financing. While the lack of venture capital activity means that many new and innovative firms do not emerge, the available evidence is insufficient to prove whether this is caused by a lack of capital supplied, a lack of liquidity in still somewhat nationally segmented venture capital markets, a lack of demand from entrepreneurs or by a shortage of exit options for venture capitalists through liquid equity markets.

B. An important aspect of the ongoing development of financial systems in industrial countries in general is the securitisation of illiquid assets. Securitisation markets are,

Further significant growth in Tanzania securitisation could help to improve the allocation of risks and free bank capital for increased lending to firms. A specific improvement that could be made to further accelerate securitisation would be to make it possible for issuers to easily include illiquid assets from Tanzania, irrespective of their location and without being hampered by obstacles in the areas of financial regulation, consumer protection or taxation.

There are, however, some issues as to whether all securitisation activities are unambiguously beneficial (some could, for example, be motivated by regulatory or tax arbitrage) and whether they could also pose risks to financial stability.

Overall, the benefits and risks of securitisation activities need to be better understood.

OTHER RESULTS

The paper finds a number of other results that are supported by at least two, but not all three elements of the analysis. These less strong conclusions are the following:

1) An important function of financial systems in general and stock markets in particular is to provide information about real investment opportunities. Various indicators suggest that in a few Tanzania countries, there is greater uncertainty about firm prospects and a lesser pricing of idiosyncratic risk. It has been shown in the literature that a low pricing of idiosyncratic risk is associated with less developed financial systems and with inefficient investment by firms. So, there seems to be some room for improving the information processing capacity of stock markets in these countries.

2) In contrast to shareholder rights, the rights of creditors in case of bankruptcy have not really improved in Tanzania over time. At the same time, previous it shows that giving secured creditors priority on the proceeds of a firm in liquidation and allowing bond holders to have a say in reorganisations increases the breadth and depth of capital markets. This raises the question as to whether some Tanzania may benefit from enhancing those rights.

3) There is a debate on whether more dispersed or more concentrated firm ownership is better for corporate performance. According to recent research, the costs of concentration appear to outweigh the benefits, but the presence of large institutional shareholders improves external monitoring. Based on the indicators of ownership concentration presented in this paper, it would seem beneficial for Tanzania capital markets if firm ownership became less concentrated, except in a few countries where the concentration is already low, and if the role of institutional investors in ownership was enhanced.

4) Financial regulation and supervision play a significant role in financial sectors by addressing market failures and enhancing stability. Available indicators suggest, however, that in a number of Tanzania some aspects of banking regulation and supervision could be improved in terms of the incentives they give banks to take and manage risks. In particular, the moral hazard implications of deposit insurance funds could be further limited. Also deposit insurance schemes could benefit from better funding solutions and more accurate pricing.

1 INTRODUCTION

The extended period of relatively slow growth and low employment experienced until recently in many Tanzania has led to increased efforts to identify policies that can improve economic performance. The reasons for the economic slowdown are manifold.

This study focuses on the financial sector and potential ways to improve both its functioning and contribution to productivity, innovation and growth in Tanzania .

This focus on the financial system seems to be particularly timely, as various recent events have put a question mark on the global competitiveness of Tanzania financial institutions and markets. For example, in parallel with the introduction of the Tanzania Shillings, financial institutions significantly extended their market share in the underwriting of the growing market for Tanzanian corporate bonds.

Moreover, a major Dar es Salaam stock exchange has merged with the others Exchanges. Last but not least, settling securities across Tanzania borders remains very costly compared. the contribution of the single market for financial services to employment and growth in Tanzania Economy.

Based on an extensive literature underlining the role of financial systems in productivity, innovation and growth, this study analyses the performance of Tanzania capital markets and their contribution to the performance of Tanzania economies. In contrast to the finance and growth literature, which concentrates very much on developing countries and emerging market economies, the emphasis is placed more on industrial countries to allow stronger conclusions for the "old" members to be drawn.

FINANCIAL SYSTEMS AND ECONOMIC PERFORMANCE – CONCEPTS AND LITERATURE

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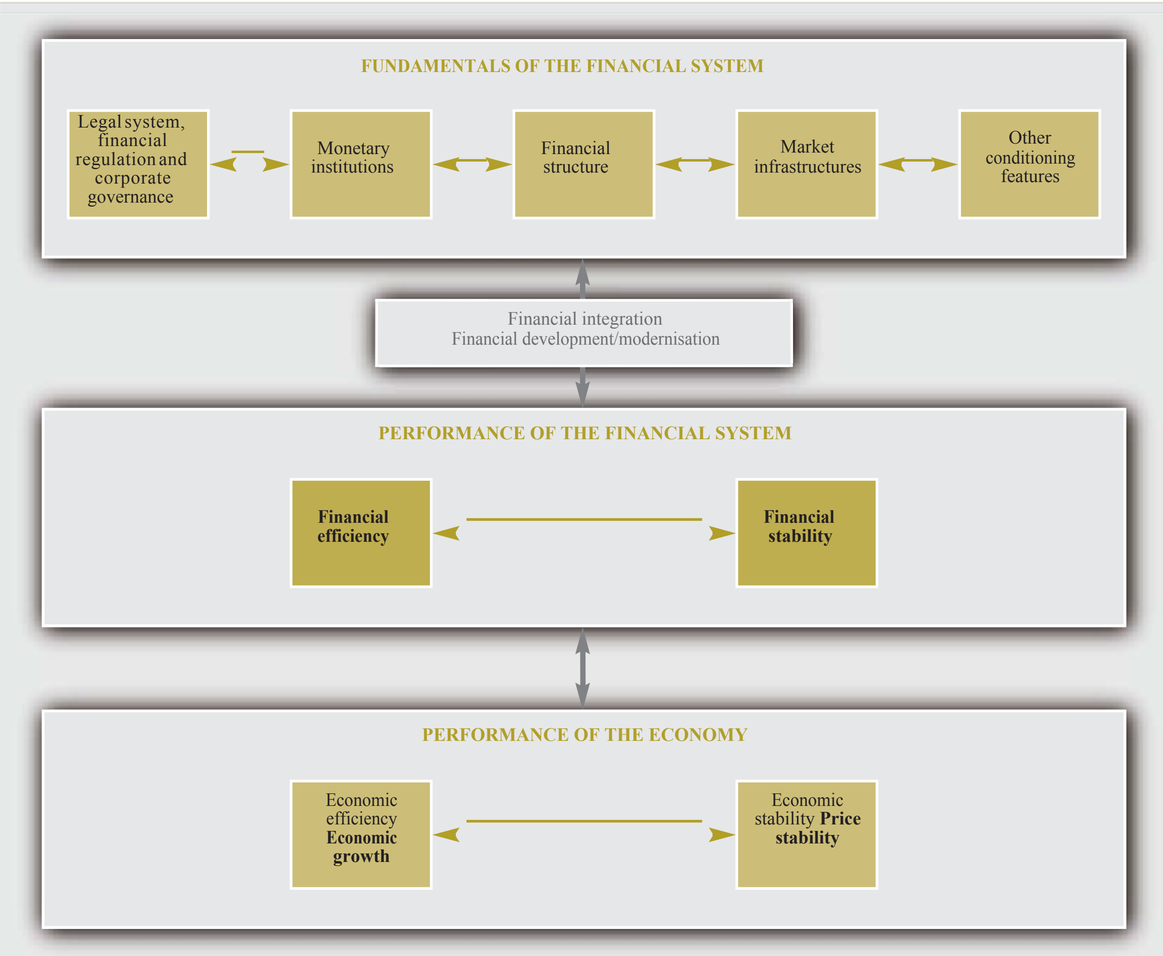
There is no widely accepted theory of financial systems that can be easily used to structure the practical discussion in the following sections. Against this background, the present section outlines a number of key concepts for financial sector work and how they relate to one another. This discussion is inspired by standard theories, which describe the role of a financial system as allocating resources from agents which have a surplus to those which have a shortage of funds.

For example, firms may see profitable real investment opportunities, but not have enough internal funds to finance them. Households may have more income than they wish to consume during part of their life-cycle and invest it in assets that return the difference with a profit at some future time, such as when their regular income is much reduced due to retirement. Finally, governments may wish to increase investment spending during recessions, drawing on the savings of other sectors. A financial system can then be defined as the set of markets, intermediaries and infrastructures through which households, corporations and governments obtain funding for their activities and invest their savings .

Chart 1 Financial system concepts and their interrelation



MEASURING THE EFFICIENCY OF THE EUROPEAN FINANCIAL SYSTEM

There are many indicators that could be used to assess how well a financial system performs its functions and overcomes the frictions described in the next page. This section builds on the empirical finance and growth literature that has already proposed a large variety of indicators to measure and quantify the functioning of financial systems and their contribution to productivity and economic growth. It presents a selection of indicators, both new and updated, which seem to suggest more substantive conclusions for Tanzania , and discusses their implications. A much larger and more comprehensive set of indicators can be found on which this Section draws.

In order to structure the analysis, the indicators are divided into eight groups, each describing an important dimension or characteristic of a financial system. The groups, which are summarised and briefly explained in Table 1, span the fundamental features of a financial system and the processes of financial development and integration.

Table 1 Dimensions of financial system performance covered by the indicators

1. Size of capital markets and financial Financial systems with larger overall capital markets provide easier financing for real structure investment. This relates to both larger securities markets and to more bank credit. Systems	that rely primarily on one but not the other may be less efficient. Also the liquidity of the different markets is relevant for this dimension.
2. Financial innovation and market completeness	Many financial innovations reduce capital market imperfections and make markets more complete. This opens up new possibilities to allocate capital across space, time and risk preferences. New financial instruments and practices, for example, allow firms to manage certain risks by shifting them to investors who have a better ability to bear them.
3. Transparency and information	Financial systems help produce and spread information about investment opportunities, market conditions and the behaviour of agents. The better they function, the lower the asymmetric information between firms and outsiders and the more information should be incorporated into stock and corporate bond prices.
4. Corporate governance	There are conflicts between insiders who control a firm and outside investors who provide financing. Better governance ensures that investors receive the full return on their investment and that there will be few deadweight costs due to opportunistic behaviour by firm insiders, with beneficial effects on the cost of capital.
5. Legal system	A key aspect of a financial system is how well it enforces contracts. As it allocates capital across time and space, contracts – either explicit or implicit – are needed to connect providers and users of funds. The legal system and the way in which it is applied by legal institutions determine the "distance" over which capital can be reallocated.
6. Financial regulation, supervision and Government intervention in financial systems tends to be stronger than in other economic stability sectors. Well designed regulation and supervision should correct for market imperfections	and enhance stability, whereas imperfect policies may have adverse effects on the performance of the financial sector.

7. Competition, openness and financial integration	Greater openness of a financial system and more competition among banks and other financial intermediaries lower capital market imperfections. Pressure from competition, for example, should ensure that financial institutions operate efficiently, earn fewer rents from market power and provide new instruments to customers.
8. Economic freedom, political and socio-economic factors	Economic freedom means the absence of constraints to economic activities, e.g. corruption, administrative burdens or political interventions that are unrelated to efficiency. Given the great importance of information, contract enforcement and ease of exchange in financial transactions, there is also a significant role for social capital in the form of cooperativeness, ethics and trust.

SIZE OF CAPITAL MARKETS AND FINANCIAL STRUCTURE

Several contributions to the literature have shown that the sizes of various capital markets, such as private credit or stock market capitalisation, can be important indicators of financial development. An important aspect of this finding is that the often cited relative share of market versus bank financing ("financial structure") is not the key variable, but that both the size of securities markets and the amount of bank lending positively affect growth.

As industrial countries are the main focus of the paper, a broad measure of capital market size is preferable to the narrower measures typically used in the context of developing and emerging market countries. Therefore, the aggregate size of stock, bond and loan markets in proportion to GDP for the sample countries.

FINANCIAL INNOVATION AND MARKET COMPLETENESS

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The principal role of financial innovation is to make markets more complete so that firms, households and governments can better finance, invest and share risk among each other . This section focuses on two aspects of innovation, securitisation and venture capital financing.

Securitisation allows for the transformation of formerly illiquid assets into portfolios of assets that can be sold widely. The risks of the associated assets can therefore be sold to economic agents that have additional capacity to bear them. Banks, for example, need to retain costly economic capital as a buffer against their risky lending activities.

Selling off some of this risk via securitisation allows them to hold less costly capital and to reinvest freed up resources into the economy. Moreover, the prices of asset- backed or mortgage-backed securities convey additional information to the market. Some securitisation may, however, be motivated by regulatory or tax arbitrage, which could entail efficiency losses.

Generally, the empirical effects of securitisation have only recently started to be analysed more carefully. It is therefore somewhat difficult to clearly assess to what extent the undoubted benefits of securitisation in Tanzania compare with open issues and risks Securitisation has recently grown substantially in a number of developed financial systems. Arguably, this growth constitutes – together with the growth of credit derivatives – the most important recent structural development in modern financial systems. The extent of securitisation of loans, mortgages or receivables for the sample countries relative to GDP, using the location of the collateral as the geographic entity.

Financing real investment projects is particularly difficult for start-ups and young and small firms which need additional capital. For these firms, asymmetric information is particularly pronounced, so that they have no access to public capital markets. Even bank financing may be difficult, as they usually have little collateral to offer. Modern financial systems therefore provide significant private equity and venture capital funds.

The related investors maintain an equity stake in firms and monitor and advise them in order as to overcome asymmetric information problems. Active venture capital markets ensure that competition and “creative destruction” promote the emergence of new firms and products.

CORPORATE GOVERNANCE

Corporate governance addresses potential conflicts between investors and firm managers and among investors, e.g. large versus minority shareholders. Better governance ensures that their interests are more aligned, so that investors obtain a better return and that there will be a smaller loss of efficiency due to opportunistic behaviour by managers. Two corporate governance issues are addressed in the sub- section: laws on securities that protect shareholders against expropriation and the pros and cons of ownership concentration.

A classic measure of good governance is the protection of minority shareholder rights in shareholder meetings.

The reliability and efficiency of legal systems are important for the performance of financial systems. The inter-temporal nature of many financial contracts implies that investors relinquish control of their funds for a promise of future cash flows. The legal system enforces the honoring of such contracts. This is exemplified by the way in which the legal system helps to enforce the creditor and

shareholder right. Research shows, for example, that international banks' investment decisions are sensitive to the enforcement of creditor rights and that stock-market turnover, private credit and market capitalisation are strongly correlated with the enforcement of shareholder rights.

ROLE OF CAPITAL MARKET SIZE

To explore the role of financial development in determining the speed of capital reallocation more formally, The estimated elasticity of investment to value-added (speed of capital reallocation) on capital market size (financial development) and other controls, such as income (economic development), human capital and the overall quality of institutions. The effect of capital market size on the investment-value added elasticity is estimated controlling for the overall level of economic development. And controls for human capital and the overall efficiency of institutional structures are added.

Obviously, It turns out that capital market size is a statistically and economically significant determinant of capital reallocation. Furthermore, it is a much stronger determinant than any of the other variables.

CONCLUSION

Building qualitatively on an extensive of this study is to underlining the role of financial systems in productivity, innovation and growth of Economy in Tanzania, this study analyses the performance of Tanzania capital markets and their contribution to the performance of Tanzania economies. The results are derived from internal and external research. They do not necessarily reflect the position of the Central Bank and the Central Bank is not committed by them. They are presented to generate discussion and identify areas in which more work could be undertaken to further substantiate advice for policy-makers. They also have to be interpreted in relation to the economic literature and to specific assumptions made by the different approaches used.

The main results of the study are those that are supported by three different elements of analysis. First, do they match the empirical and theoretical results of the existing literature? Second, are they confirmed by indicators that quantify the state of development of Tanzania financial systems? And third, does the econometric analysis show a link between certain indicators of financial development and the speed with which capital is reallocated from declining to rising industry sectors?

① The main results are that the size of capital markets is a useful summary statistic of the overall financial development of an economic region,

② it may be advisable to remove obstacles preventing efficient legal action by minority shareholders in publicly traded firms against self-dealing by corporate insiders,

③ a fast resolution of financial conflicts by a legal system improves financial development and the swift reallocation of capital, and

④ certain structural features of Tanzania bank sectors may hamper financial development.

The study also derives a number of other results that are supported by at least two but not all three elements of the analysis. These less strong results relate to the information processing capacity of Dar es Salaam stock markets, creditor rights, ownership concentration in large publicly traded firms and the regulation of banks. Finally, the study points out that more research is needed on the important issue of Dar es Salaam risk capital markets, i.e. venture capital financing and the securitisation of illiquid assets.

The elements of analysis employed in the study have some advantages and disadvantages that must be kept in mind. The use of indicators of financial development gives a comprehensive view of a financial system and allows identifying those issues that require further attention. The indicators are firmly grounded and have been used before in the comprehensive economic literature, and they allow to cross-check the econometric analysis. But not all aspects of Tanzania financial systems may be fully captured by the indicators. The constraints imposed by data unavailability and non-comparability are significant. Moreover, publicly available data may not capture issues that can only be identified by those individuals that are active in financial markets. While formal laws and rules are easier to measure, informal rules could be just as influential. Information is often available on wholesale, market-based activities but not on retail, relationship-based activities.

The econometric analysis in this study focuses on the reallocation of capital across industries. Although important, it is only one among many mechanisms through which a financial system may affect productivity and economic growth, eg. capital deepening, human capital accumulation or the adoption of new technologies. The econometric analysis is silent about the existence of such other mechanisms and whether the issues identified here are similar or different for them. The estimation approach addresses a number of identification problems, such as biases arising from omitted variables, unobserved heterogeneity and reverse causality. But since it uses many of the indicators of financial development, the same caveats listed above apply.

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