

Case Study

Public Debt Management, Cash Management, and Domestic Debt Market Development

Tanzania

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**Macroeconomic and Financial Management Institute of
Eastern and Southern Africa
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ACRONYMS AND ABBREVIATIONS

AGD	Accountant General’s Department
BoT	Bank of Tanzania
CDS	Central Depository System
CMSA	Capital Markets and Securities Authority
COMSEC	Commonwealth Secretariat
CS-DRMS	Commonwealth Secretariat Debt Recording and Management System
DCC	Debt Coordination Committee
DebtPro	debt management software developed by International Debt Management
DMC	Debt Management Committee
DMO	debt management office
DSA	debt sustainability analysis
DSE	Dar es Salaam Stock Exchange
DSM+	Debt Sustainability Model Plus software developed by the World Bank
EFD	External Finance Department
FO	front office
GDP	gross domestic product
HIPC	Heavily Indebted Poor Countries (Initiative)
IDA	International Development Association
IFMS	Integrated Financial Management System
IMF	International Monetary Fund
MDF	Multilateral Debt (Relief) Fund
MEFMI	Macroeconomic and Financial Management Institute of Eastern and Southern Africa
MO	middle office
MPC	Monetary Policy Committee
NBC	National Bank of Commerce
OTC	over-the-counter
PAD	Policy Analysis Department
PRSP	Poverty Reduction Strategy Paper
TRA	Tanzania Revenue Authority
TZS	Tanzania shilling

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This case study was prepared by a joint mission of the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI), National Treasury of the Republic of South Africa, World Bank, and International Monetary Fund (IMF) that visited Tanzania June 11–22, 2001. The mission team was led by Fred Jensen (World Bank) and included Anna Msutze and Cornelius Deredza (MEFMI), Jacob Lushinga (MEFMI fellow, Bank of Zambia), Phakamani Hadebe (National Treasury of the Republic of South Africa), Paddy Maloney (consultant), Mark Zelmer (IMF), and Elizabeth Currie and Pierre Yourougou (Banking and Debt Management Group, World Bank).

All the statistical and background information and the description of current practices presented in this case study are based on the discussions the mission team had with Tanzanian officials and the information published by IMF, the Bank of Tanzania (BoT), and the Ministry of Finance (MoF) of the United Republic of Tanzania and available at the time of the mission. The initial draft of this report was presented to Tanzanian authorities for comments, and the final report benefited greatly from their inputs. This report is the result of the collaborative effort of all the participants, including our Tanzanian hosts. However, the mission team solely bears the responsibility of any errors that may remain.

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UPDATE

Since the mission was held in June 2001, the government of Tanzania has made significant progress in various areas of their public debt management reform programs. A new document, “National Debt Strategy: Domestic and Total Debt,” which was approved by the cabinet and published in August 2002, outlines the new public debt management policy of the government. Some of the policy changes contained in this report have already been implemented and are indicated by an asterisk in this list of updates. The major policy changes are listed below.

OBJECTIVES AND COORDINATION

- The objectives of debt management have been explicitly defined: Manage public debt in a way that meets the government’s gross funding needs at the lowest possible long-term cost, with due regard to the underlying risks. The development of the secondary market is a secondary objective of debt management.
- Formally separate the liquidity management and financing instruments to strengthen the credibility of monetary policy tools. The 35-day treasury bill was reintroduced (and the 60-day treasury bill will be introduced later) to accommodate the short-term cash-management needs of Ministry of Finance (MoF) and allow the Bank of Tanzania (BoT) to concentrate on the shorter end of the yield curve, allowing the 182- and 364-day treasury bills to serve as purely financing papers.

TRANSPARENCY AND ACCOUNTABILITY

- Establish a centralized debt management unit within the Treasury (MoF) with all the front office, middle office, and back office functions.
- Require the MoF to submit a quarterly debt report to the cabinet as part of the budget execution reporting process and an annual future debt strategy to the cabinet for that body’s approval as part of the budget submission.

LEGAL FRAMEWORK AND INSTITUTIONAL ARRANGEMENTS

- Restrict the power of borrowing and managing public debt to the MoF. Those who violate this restriction would be reported to the Parliament by the Controller and Auditor General.
- Legally establish a National Debt Management Committee to monitor, coordinate, and direct the activities of all government departments and institutions involved in public debt management. This committee will also advise the MoF on the formulation of the annual public debt strategy to be submitted to the cabinet for approval at budget time.

STRUCTURE OF DEBT MANAGEMENT OPERATIONS

- Strengthen and enlarge the Policy Analysis Department to carry out analysis of overarching total debt issues such as the balance between external and domestic debt, trading off currency risks of external debt versus the interest and rollover risks of domestic debt, developing an assessment of the fiscal sustainability of total public debt, and the like.
- Develop a single official public debt database at the Public Debt Unit in the Accountant General's Department (AGD), after a rigorous reconciliation between the two parallel databases presently maintained at the AGD and BoT.
- Develop a network link among the Treasury (MoF), BoT, Tanzania Revenue Authority (TRA), and AGD so that debt-related tasks and revenue data can be shared in real time.
- Address the capacity needs at the MoF by recruiting staff according to market remuneration standards and seconding BoT staff to the MoF.
- Make arrangements to use experienced MEFMI fellows to provide in-house training to the staff in MoF, especially in the AGD, Policy Analysis Department, and External Finance Department, which will form the nucleus of centralized debt management in the medium term.

STRATEGIC FRAMEWORK AND RISK MANAGEMENT

- Formulate a comprehensive national debt strategy that covers all aspects of debt management, including an integrated sustainability and cost-risk analysis of external and domestic debt.

- Centralize debt and guarantee issuance within the MoF.
- Quantify the domestic contingent liabilities arising from normal government operations as well as the public sector: strengthen the capacity of the Treasury Registrar to record and monitor parastatal-related debt developments on a continuous basis and require the Treasury Registrar and Parastatal Sector Reform Commission to produce annual statements of outstanding liabilities of the parastatal sector.

CASH MANAGEMENT

- Consider a more active management of the short-term domestic debt obligations (treasury bills) to manage the mismatch between cash receipts and expenditures.
- Make changes to the rules governing the TRA's tax collection arrangements so that funds deposited with commercial banks are transferred to the TRA account at the BoT on either the same day or the following day.

DEVELOPING THE MARKET FOR GOVERNMENT SECURITIES

- Long-term tradable bonds in key maturities (5, 7, and 10 years) have been or are to be launched to roll over maturing stocks and special bonds and meet other debt-structuring or long-term project funding needs.
- The frequency of bond auctions has been reduced from weekly to monthly, and price-based rather than coupon-based auctions have been adopted.
- Securities issuance frequency and amounts are now publicized at the start of every quarter to help investors plan their investments.
- Launch a national personal saving scheme by issuing saving certificates in 3-, 5-, 7-, and 10-year maturities to encourage personal savings in the economy, diversify the sources of long-term funding for government development projects, provide individuals with easy and inexpensive access to government debt products, and compensate for relatively undeveloped structures of financial intermediation.
- To strengthen the credibility of the announced tender size in auctions (for both liquidity and financing paper), take measures to ensure that the firmed-up tender size always aligns with the amount actually auctioned.
- To strengthen the primary dealership system, introduce meaningful privileges (exclusive access to primary auctions), strict criteria (capital adequacy, trading infrastructure), and market-making responsibilities (continuous two-way price making) for primary dealers.

MONEY MARKET

Expand the role and application of horizontal repurchase transactions (repos and reverse repos) in the trading of treasury bonds.

CENTRAL DEPOSITORY SYSTEM FOR GOVERNMENT SECURITIES

The book-entry system has been instituted, and the issuing of physical certificates for ownership of securities has been stopped after an awareness campaign.

SUMMARY

PURPOSE AND SCOPE

Staff from the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI), the World Bank, and the International Monetary Fund (IMF) visited Dar es Salaam during June 11–22, 2001, to prepare a case study on Tanzania’s cash and debt management practices and the development of the domestic debt market. (In light of recent developments in public debt management that were summarized in the “Update” section, any reference to “current practice” “present time” should be understood to mean June 2001, the time when this report was first drafted.) This case study is published by the World Bank and MEFMI and will be used by MEFMI in its efforts to build government cash and debt management capacity in eastern and southern Africa.

PUBLIC DEBT MANAGEMENT

Every government faces policy choices concerning how to manage its debt, including the sources of financing, the scope of the debt to be managed, how to manage contingent liabilities, how to coordinate debt management with other public policy objectives, and how to structure the legal authority for borrowing and the institutional arrangements for carrying out this authority. Although practices differ, there is a growing convergence on the basic principles of sound public debt management. These include:

- The importance of clear objectives for public debt management and the need for careful coordination of debt management objectives and practices with other public policies.
- The benefits of transparency of debt management objectives and policies and clear accountability for achieving these objectives and implementing the policies.
- The importance of a well-specified structure of governance that provides for clear authorities and responsibilities, including the legal framework and the organizational structure, as well as the capacity of the staff and systems within this organizational structure to carry out their responsibilities.
- The need for a clear framework for evaluating alternative strategies for managing the government’s debt and determining the appropriate strategy, and the importance of evaluating the costs and risks of these strategies in this evaluation and managing the risks.

The following sections summarize the findings and recommendations in each of these areas of debt management.

Objectives and Coordination

At the time of the study, there were no explicit policy objectives for managing total public debt in Tanzania. The project to develop a strategy for managing domestic debt is expected to lead to an integrated strategy for managing fiscal sustainability of both domestic and external debt, and this is a step in the right direction. However, there is no mention of risk, and, as with the current strategy for external debt, the effect will be to focus exclusively on cost without regard to risk.

Given the need to maintain external debt sustainability and fiscal discipline and keep the costs of new funding low, the objectives for fiscal, monetary, and external debt management policies are now being coordinated. An integrated strategy for debt management based on fiscal sustainability, as envisioned under the project in progress, should ensure that such coordination also extends to the objectives for managing domestic debt. Moreover, the new domestic debt strategy will be based on a fiscal sustainability analysis, and this coordination should extend to the analysis of macroeconomic strategies as well.

There have been a number of improvements in the forecasting of government cash flows and coordination between the government and the BoT in sharing information on cash balances and forecasts, and this has improved the ability of the BoT to manage the liquidity of the banking system. Even so, a number of additional improvements can be made.

As long as the domestic market remains limited to short-term instruments, there will be potential for conflict between monetary policy and debt management objectives. The government's plan to further develop the market for domestic debt instruments will have the effect of lengthening the maturities available on domestic debt to meet the government's financing needs and will help manage the potential conflict between monetary policy and debt management objectives. In the meantime, though, there will be a need for very careful coordination of debt issuance for the two purposes.

Regarding the separation of accountability for monetary policy and debt management, the BoT is currently responsible for all elements of managing domestic debt, other than the policy of rolling over debt that has been issued for financing purposes. However, the strategy for managing the yield curve, except at the very shortest end, is usually the province of the debt manager.

Recommendations

- The government should develop explicit objectives for debt management, including as a primary objective a consideration of both cost and risk, in addition to the objective of meeting the government's funding requirements. The development of the domestic debt market should also be included as a secondary objective.
- The capacity for analyzing domestic and external debt could be strengthened, and sustainability analysis should be carried out more frequently, at least annually. This will help to ensure the ongoing coordination between debt management policies and objectives and those of fiscal and monetary policy.
- The accuracy and timeliness of information on government cash balances and forecasts of cash flows should be improved. This will help the BoT better manage the liquidity of the banking system.
- When circumstances permit, there should be a separation of instruments used for debt management and monetary policy, and the accountability for managing the government yield curve should be transferred from the BoT to the government.

Transparency and Accountability

There are no policy issues in the area of transparency at present. Tanzania exemplifies sound practice in this area. With respect to accountability, Tanzania also exhibits sound practice in publishing information on debt management accountabilities. However, transparency and accountability would be aided by a simpler structure for decisionmaking and, to the extent possible, consolidating authority for debt management in a central unit. Many different units now have responsibility for different aspects of debt management, and decisionmaking is shared by a number of committees made up of representatives from these various units. Spreading responsibility over a number of committees and units tends to diffuse accountability.

Recommendation

- Transparency and accountability would be enhanced by streamlining, to the extent possible, the decisionmaking process and consolidating authority for debt management within a single unit in the MoF.

Governance

Legal Framework

The proposed draft legislation, by establishing the Minister of Finance as the sole authority for debt issuance, would allow greater control of debt issuance. Creating ceilings on guarantees, confirming that fuller information needs to be given to the Tanzanian Parliament on the amounts to be raised in the financial year, and establishing the need for the assembly's authorization to carry out the funding when they have been assured of preliminary compliance with debt ceilings will help to avoid potential abuse of power. Although a controlling ceiling is undoubtedly necessary, it may be more convenient if the limits are not established as a permanent, fixed, notional amount but instead take into account the necessary macroeconomic and debt sustainability analyses, as well as changing circumstances.

Appropriate enforcement of this legal framework is vital. The framework has been poorly administered in the past: public sector officials obtained funding without the consent of the finance minister. This in turn contributed to violations of the debt ceilings, which fed into the debt's lack of sustainability. However, no sanctions were applied to the public officers who had contracted loans without authorization.

Apart from the creation of debt ceilings, the draft legislation does not mention accountability safeguards. The Parliament also needs to verify, through appropriate reporting requirements, that the powers it has delegated to the finance minister are being used in an orthodox fashion and the debt management the minister supervises will not lead to debt sustainability problems.

There have been substantial defaults in debt servicing in the past, and this created debt-servicing uncertainty, which can contribute to a higher cost of debt. Countries sometimes include provisions in their legislation to reduce uncertainty about future compliance in debt servicing, but at the moment it could be difficult to incorporate this in debt management legislation in Tanzania.

Recommendations

- Seek better enforcement of the legal framework for public debt management, and apply strong sanctions for violations. The provisions for sanctions may be contained in legislation, or in regulations, but in any case they must be strictly enforced to obtain the minimum discipline in the debt management process.
- Include provisions for greater accountability of the MoF to the Parliament, with periodic reports covering important aspects of public debt management. The precise nature of the reporting varies from country to country.
- In the medium term, one alternative that could be explored to reduce debt-servicing uncertainty and improve creditworthiness in the eyes of local investors, international lenders, and donors would be to create a permanent appropriation for all debt service, which would enable the government to service debt regardless of the amounts forecast in the annual budget.

Institutional Arrangements

The institutional arrangements are characterized by a high degree of dispersion of debt management functions, both between the MoF and the BoT and within the MoF. In addition, there is duplication of some functions by these two entities, which on occasion has led to operational difficulties as serious as delays in debt services.

The fragmentation of responsibilities implies a need for high coordination and the continual processing of information flows, which places strains on institutional arrangements. This can also lead to a fragmentation of the strategy for debt management; policy may focus on a particular portion of the debt, but for debt sustainability analysis and risk analysis in general, it is essential to have an integrated view of the whole debt portfolio. Consolidation of the debt management functions can lead to efficiency gains, which can also help address the shortage of qualified staff.

Recommendations

- Centralize and consolidate debt management responsibilities to the extent possible. If debt management functions are eventually centralized at the MoF, then ideally they should be consolidated in one unit, a debt management office (DMO). If this is impossible in the near term, an alternative is to create a stronger coordinating mechanism within the ministry, such as an internal debt committee. A full transfer of responsibilities from the central bank to the MoF cannot be implemented until more permanent capacity is developed at the MoF.
- Improve coordination of monetary and debt management policy. Although, for the time being, monetary policy in Tanzania will continue to be implemented through the primary market, debt managers at the MoF can develop a domestic market debt strategy and provide their inputs to decisions on primary issuance. The MoF and the BoT can negotiate their preferences for achieving their different objectives, and there may be opportunities to accommodate their respective needs.
- Activate committees for coordination with outside entities. Regardless of whether a DMO is consolidated or not, the nature of the funding process in Tanzania involves a sufficiently high number of entities external to the MoF, which merits a greater activation of the debt management committees with strict enforcement of the regularity of the meetings.

Structure of Debt Management Operations

Public debt management involves not only financial market exposure but also significant operational exposure. Failure to correctly implement a funding transaction, service the debt, register debt contracts, or maintain exact and updated debt statistics can have costly implications for a government. Sound public debt management requires staff with a good combination of financial, macroeconomic, and public policy skills. The ability to recruit and retain highly skilled debt management staff is absolutely crucial for mitigating both policy and operational risks.

Unfortunately, staff capacity is relatively weak in Tanzania's MoF, and this is an important factor explaining its limited role and the duplication of its functions by the BoT. Some units in the MoF are understaffed, and, in general, technical capacity is relatively low and turnover is high. This is largely a reflection of the low civil-service remuneration of MoF staff relative to their private sector and BoT counterparts.

Recommendations

- Provide better remuneration and benefits for public debt managers at the MoF. Sound public debt management requires staff with a good combination of financial market skills and public policy skills. The ability to attract and retain highly skilled debt management staff is unquestionably necessary for mitigating both policy and operational risk
- If there is an intention to eventually transfer most of the debt management functions from the BoT to the MoF, then a more comprehensive approach to salary upgrades and benefits is needed to permanently strengthen long-term capacity for public debt management in the MoF. This should include a training budget, which is of great importance to staff and which may help to compensate the relatively low salaries in comparison with the central bank and private sector, as seen in other countries. In addition, numerical staffing needs should be met by filling authorized positions; this, however, probably depends on civil-service reform.
- In the short to medium term, it may be possible for the government to motivate staff by recognizing their capabilities and minimizing the use of external consultants in assignments that can be done by local staff.

The BoT does have experienced staff who have been through the MEFMI fellows program and are conversant with the Commonwealth Secretariat Debt Recording and Management System (CS-DRMS), loan interpretations, data validation, and simple analysis of the debt portfolio. Arrangements should be made for these staff members to provide in-house training to the newly recruited staff in the MoF. In addition, a well-articulated training program that is relevant to the day-to-day functions of the back office needs to be developed and funded appropriately.

Front office. Tanzania does not have a centralized debt management department or unit. The front office (FO) activities are shared among various departments. This increases the importance of more effective coordination among the institutions and departments involved.

For the FO external debt functions, the External Finance Department (EFD) has the mandate to interact with Tanzania's development partners and coordinate donor support. However, sector ministries and parastatals may also contact and negotiate directly with identified financiers for projects in addition to those approved and incorporated in the budget framework. The MoF's Policy Analysis Department (PAD) takes the lead in negotiation of debt reorganization and restructuring through the Paris Club and the Heavily Indebted Poor Countries (HIPC) Initiative.

The BoT Financial Markets Department has the responsibility for issuance of domestic debt instruments. However, in the past, line ministries have directly contracted nonsecuritized debt through accumulation of domestic arrears or suppliers' credits. The MoF has since taken measures under the cash budget system to stop this practice.

The 1974 Loans, Guarantees and Grants Act is out of date, and it is most likely that its borrowing ceilings have become obsolete. The draft of the revised act has been prepared for Parliament's authorization.

Project follow up, although recognized as necessary, is constrained by lack of human and financial resources. This affects the disbursement rates for donor-funded projects and can increase the risk of accumulating undisbursed balances in the debt portfolio.

Recommendations

- Promote the consolidation of FO functions into one unit, or at a minimum strengthen coordination among the units involved in FO activities. Given the level of expertise required in dealing with donors, it is important to maintain a single contact point for negotiations with donors. Therefore, the MoF's EFD may need to help sector ministries and parastatals by leading the identification and negotiation with potential donors. In addition, the EFD can also be more involved in loan renegotiations, if this is deemed appropriate for integration of the negotiation function.

It is important that project appraisal by the Planning Commission of national priorities be adhered to in all cases before entering into any commitments with financiers or beneficiaries. Speedier appraisal of projects and related funding could encourage sector ministries to follow through the entire evaluation process.

The requirement that all projects earmarked for donor funding should be first assessed for national importance by the Planning Commission plays an important role in the analysis before contracting loans, and it should be continued.

- Continue efforts to prepare a domestic debt strategy covering domestic debt and contingent liabilities. This will help guide domestic borrowing consistent with the proposed new Loans, Guarantees and Grants Act and fiscal and monetary policy objectives and targets.
- Ensure that the new Loans, Guarantees and Grants Act incorporates guidelines set in the External Debt Strategy of 1999 for consistency between the two documents.

The proposed new act will need to be synchronized with the loan evaluation approach contained in the External Debt Strategy of 1999.

The parameters set in the External Debt Strategy Document may not be legally binding. The new Loans, Guarantees and Grants Act could specifically refer to the External Debt Strategy and the Domestic Debt Strategy (once it is completed and approved) as legally binding documents, to be read in conjunction with the act itself.

- Involving civil-society organizations in the institutional framework for debt management may pose special challenges, but it is important to make information about the level, terms, and purposes of government borrowing routinely available to them.

Middle office. There has been a significant improvement in the analytical work carried out on public debt management, and future activities have been programmed for the near and medium term. This contributes to the debt being managed in a more strategic and sustainable fashion. However, there are multiple challenges to be resolved, and this can only be done gradually, in pace with the strengthening of the staff's technical capacity.

At present, debt funding strategies do not incorporate risk in a systematic and quantifiable manner. For the moment, debt sustainability is analyzed in terms of simple ratios, which is useful and appropriate for basic debt sustainability analysis (DSA), but a more complete analysis would involve scenario simulation, with both deterministic scenarios and stochastic exercises.

The CS-DRMS works on a loan-by-loan basis, which may make it tedious for middle office (MO) staff to analyze different aggregate portfolio structures under a number of different scenarios. Consequently, it could also be difficult for MO staff to carry out the analyses necessary for the proposal of basic debt management targets, such as currency composition or amortization profile.

Recommendations

- Strengthen the technical capacity of the MO staff, especially staff at the MoF, by improving remuneration and providing major training opportunities to retain trained staff.
- The MoF should periodically carry out DSA and include both foreign- and domestic-currency debt in the analysis.
- Introduce the risk dimension into debt strategy by extending DSA beyond simple ratios to more complete fiscal sustainability and scenario analyses.

In the medium term, the risk analysis should develop from a simple, deterministic set of currency and interest rate scenarios to a more stochastic exercise, and it should be used to evaluate different funding strategies in terms of their cost and risk dimensions. This would enable the MoF to decide on the level of debt service volatility that can be tolerated in return for a lower cost of debt. Specific training can be obtained for this kind of evaluation.

CS-DRMS should be supplemented with software such as Debt Sustainability Model Plus (DSM+) or DebtPro, which will simplify the analysis by enabling evaluation more along the lines of a portfolio. A formalized link already exists between CS-DRMS and DSM+, so this could be a possibility to consider.

- Based on sensitivity analyses, MO staff could periodically inform the macroeconomic programming units in the MoF and BoT of the impact of differing debt-servicing scenarios on fiscal and monetary variables. Likewise, macroeconomic programming under varying scenarios should be regularly incorporated into the projected debt-servicing analysis.

This type of analysis would enable the MoF to propose some basic targets, such as the external-internal debt mix (in terms of cost and risk and also influenced by macroeconomic policy directives, as well as funding constraints) and desired amortization profiles. Although there are certain limitations in the concessional funding with regard to currency and interest rates, scenario analysis could be carried out by MO staff to quantify risk of an increase in debt servicing on the government budget.

- The MO can act as secretariat for the debt committees (the Debt Coordination Committee [DCC] and Debt Management Committee [DMC]) by preparing periodic reports on the debt portfolio and proposed strategic guidelines, ultimately to be chosen and authorized by the minister.

Recommendations (cont'd)

- MO staff should inform other interested parties—such as the Parliament, bilateral donors, HIPC officials, and so on—of the state of the debt portfolio with reference to the approved strategy, explaining the risk-cost tradeoffs chosen by the government.

Back office. Under the current procedures, external loan disbursements are recorded by both the Debt Department of the BoT and the Accountant General's Department (AGD). This duplication of efforts results in delays of new loan registration and even transactions.

The domestic debt databases of both the BoT and the AGD are incomplete. Although the BoT records stocks and bonds in the CS-DRMS, its database excludes treasury bills. Likewise, the AGD records treasury bills in the CS-DRMS, but stocks and bonds are registered in spreadsheets. Furthermore, there is no database on contingent liabilities.

Although the BoT Debt Department and the AGD work in close collaboration to validate the databases, it is done on an ad hoc basis. The validation exercise is further complicated by the shortage of skilled staff in the AGD. There is a serious problem of staff motivation, largely because of low remuneration.

Recommendations

- Develop a shared network link between the MoF and the BoT so that tasks can be shared. Given the government's desire to have the responsibility of the debt data, arrangements should be made to allow only a few key individuals to access the database and make changes.

The domestic debt database is incomplete at both the BoT and the MoF. To remedy the situation, arrangements should be in place to allow for one site where comprehensive domestic debt data will be maintained and regularly available for analytical purposes. This can be done in the new CS-DRMS 2000+, which has the facility to record all domestic debt instruments. To speed up the process, an institution should be made responsible for this task. At a later stage, the information could be accessed by both the BoT and the MoF through an electronic link, as in the case with the external debt database.

- Continue to negotiate with donors to reach an agreement that would allow quarterly submission of reports that provide information for updating data on disbursements.
- Develop good internal controls that would automatically identify discrepancies in loan transactions and allow an accurate and timely servicing of the debt.

There is need to develop a timetable that specifies the frequency with which validation ought to take place, including joint exercises between the AGD and the BoT. Guidelines for data validation should be available to relevant staff in the department to help them conduct the exercise with more accuracy.

Strategic Framework and Risk Management

Although the government should be applauded for preparing a detailed strategy for managing its external debt, there is a need to take into account the risks of external debt, notably exchange rate risk. The volatility of exchange rates poses risks to the sustainability of the external debt burden. To manage these risks, an explicit treatment of both the cost and risk of external debt should be incorporated into the strategy.

Going forward in the aftermath of enhanced HIPC debt relief, domestic interest payments will have a larger fiscal impact than interest on external debt. Consequently, the project for developing a domestic debt strategy is very timely, and its completion should be a high priority. Updating the DSA for external debt and performing an integrated fiscal sustainability analysis of domestic and external debt are important elements of this project. However, the extent to which the project will include the management of contingent

liabilities is not clear. These liabilities pose potentially substantial risks to the budget and could result in large, unexpected future debt issuance by the government.

The strategy for domestic debt can then be integrated with the strategy for external debt. The risks of domestic debt are also substantial, and choices between domestic and external debt could have significant effects on the risks to the fiscal sustainability of government debt. The risks of domestic debt include interest rate and rollover risk. In a combined strategy for domestic and external debt, a balance will need to be struck between the cost and exchange rate risk of external debt, and the interest rate and rollover risk of domestic debt. Hence, any joint strategy for managing debt will need to be based on a cost-risk analysis of the debt as a whole. The strategy for developing the domestic debt market will need to be explicitly included in this analysis, because the pace of development of these markets will affect the range of instruments available to the government to choose from when considering cost-risk tradeoffs.

Recommendations

- An integrated sustainability and cost-risk analysis of external and domestic debt should be conducted.
- Updating the DSA for external debt and performing an integrated fiscal sustainability analysis of domestic and external debt are critical components of establishing a domestic debt strategy, and they should be given a high priority. In addition, the econometric study of fiscal sustainability could be supplemented by a simpler analysis of the implications of debt service on the budget and other macroeconomic policy objectives through a macroeconomic programming exercise.
- The analysis of cost and risk of alternative debt strategies can begin with simple scenario analysis, using existing tools, and more sophisticated models can be added once staff have developed the necessary capacity.
- The government should choose a strategy based on the costs and risks of the alternative debt strategies, taking into account its tolerance of risk and the vulnerability of fiscal sustainability to these risks. The approved strategy can then be translated into explicit guidelines or targets to guide new debt issuance.
- The project for developing a strategy for managing domestic debt should include an action plan for performing cost-risk analysis and incorporating this into the integrated strategy for managing domestic and external debt, as well as contingent liabilities.
- Contingent liabilities need to be carefully monitored and controlled, and policies governing the use of guarantees should be strengthened.
- The future use of guarantees should be limited to beneficiaries that are financially sound. Over the medium term, the capacity to evaluate potential losses on guarantees should be developed, and policies governing the use of guarantees should take these into account.
- Data on debt issuance of past privatizations should be compiled, and the project for creating a database of the outstanding debt of parastatals that remain to be privatized should be given a high priority. These data can be analyzed to give insight into potential future needs to issue government debt to recapitalize parastatals for privatization.
- Procedures for ensuring repayment of on-lent loans need to be tightened.

CASH MANAGEMENT

Cash management is the process by which the government projects and manages its day-to-day cash inflows and outflows. DMOs that exemplify best practice in developed markets typically manage these cash flows daily. To be effective, cash management requires a regular process of monitoring the expected payments and receipts, and the forecasts need to be continuously updated to reflect the latest revenue and expenditure data.

Budget Process

In 1996, Tanzania adopted a policy of cash budgeting, whereby expenditures take place only when the means of financing have first been secured. A new Integrated Financial Management System (IFMS) was introduced in 1998 to better control expenditures and avoid a buildup of unauthorized arrears. The introduction of the new Public Finance Act and associated regulations, in July 2001, provides an ideal opportunity to undertake a more stringent control of new arrears and reinforce the importance of budget discipline across the government.

Recommendations

- The audit of past arrears should be completed as soon as possible, so that provisions can be made for the amounts due. This process should be accompanied by an announcement from the government that no more arrears will be accepted.
- A more stringent inspection and discipline process could be introduced with the new Public Finance Act to reinforce the new rule that there are to be no more unauthorized expenditures without the necessary budget approvals and sanctions will apply to those who break the rules.

Revenue and Expenditure Management

The accuracy of the forecasts of tax revenue paid by taxpayers to the Tanzania Revenue Authority (TRA) is not clear. Moreover, delays in the transfer of tax receipts from the TRA's accounts with commercial banks to its account at the BoT provide commercial banks with an interest-free float that can be profitably redeployed by the banks into interest-earning assets.

Recommendations

- Changes could be made to the rules on the TRA's tax collection arrangements so that funds deposited with commercial banks are transferred to the TRA's account at the BoT for either same- or next-day value, and there should be rules in place to compensate the government for lost interest if transfers are delayed. Moreover, the BoT should transfer the credit to the MoF's exchequer account the day it receives the funds from either the TRA or a commercial bank.
- Work should be undertaken to forecast tax revenues and expenditures daily. This would ensure that the MoF receives its tax receipts as soon as they are due. Moreover, the BoT needs these forecasts to manage the amount of liquidity in the financial system on a daily basis.

Donor-Financing Issues

The MoF needs to have accurate forecasts of when donor flows will be received so that budget credits can be recorded as soon as possible. Some donors are very good at providing advance notification of when they will be making payments, but others are less forthcoming. The absence of reliable information from the latter group presents major difficulties for the ministries involved, because they cannot plan and execute their projects reliably. It also complicates the BoT's ability to manage its foreign reserves and sterilize these flows for domestic monetary policy purposes.

Recommendation

- To the extent possible, additional efforts should be made by the MoF to strongly emphasize to the less cooperative donors that the quality of the government's project work in the area relevant to their grant is adversely affected by the inability to properly plan the timing of the work involved.

Debt-Servicing Payments

There have been occasions when the BoT has rejected a payment instruction from the AGD for debt servicing because it could not reconcile the payment with its own database. It is important for Tanzania's reputation that all debt service payments are made on time, and these payments should not be delayed because of internal differences in databases.

There have also apparently been delays in making debt service payments by the BoT because of a late delivery of the check from the AGD to the BoT. Internal measures should be adopted by the two institutions to ensure that this does not recur.

Recommendations

- A system of advanced reconciliation of the debt records between the AGD and the BoT should be introduced to ensure that debt service payments are not delayed just because the two agencies have a difference in their own internal records.
- At the end of each month, the AGD should provide to the BoT and the lender a list of all the debt service payments that are due to be paid in the coming month, including the amounts of interest and principal, the payment dates, and payment instructions.

This list should be given to the BoT at the end of each month, and the BoT could then reconcile all these upcoming payments before the due payment dates. Achieving this reconciliation and agreement well ahead of the payment date will eliminate the need to withhold a payment because the two databases are not reconciled. This system might also overcome the need to write separate checks for each debt service payment.

Debt Issuance Decisions, Alternative Maturities, and Liquidity Management

The MoF holds large deposits with the BoT, which are used to manage day-to-day cash inflows and outflows. There is an opportunity cost associated with holding cash balances. Consequently, the government may wish to consider more active management of its short-term domestic debt obligations (treasury bills) to manage the mismatch between cash receipts and disbursements. This could include issuing treasury bills with tenors shorter than 91 days, as well as accessing its short-term advance facility with the BoT when market conditions are not conducive to borrowing in the market.

Recommendations

- The MoF should be the agency responsible for deciding the volume of government bills and bonds to be issued in the weekly auctions for financing purposes.
- The MoF could use a wider range of maturities to meet its borrowing requirements. This is especially the case when it needs to borrow for relatively short periods, such as shorter than 91 days.
- Flexible financing arrangements could be provided by the BoT to the MoF to ensure that the ministry can obtain funding when accessing markets directly is not practical.

Operational Risk and Staffing Issues

Although the government's financial management system is technically very efficient and has contributed to better management of government finances, the system must be properly maintained in the coming years to ensure that it continues to function properly. Moreover, the current high turnover rate among highly trained staff means that the cash management system and the quality of financial management may not realize their potential.

Recommendations

- Provision should be made in the government's budget for the necessary funding to ensure that the cash management system (that is, the IFMS) remains fully operational and does not break down.
- Attention should be given to the difficult staff retention issues within the MoF, especially in regard to the cash forecasting requirements and the maintenance of the IFMS. This raises the question of the adequacy of salaries for affected personnel relative to the private sector, which may require additional financial compensation. Moreover, it is critical that provision be continuously made for an adequate training budget.

IMPROVING THE FUNCTIONING OF DOMESTIC DEBT MARKETS

Government securities are mostly purchased by banks and pension funds at auction and held until maturity. Despite the introduction of a primary dealer system, a book-entry system, and

ongoing reforms to the payment system, there is almost no secondary market trading. The reason for this is that the banks and pension funds have a strong desire to hold these securities on their balance sheets until maturity, because the yields on government securities have been considered attractive relative to lending to enterprises and households. Indeed, demand for these securities continues unabated, even though their yields are now below the rate of inflation because of a lack of alternative investment opportunities.

The preceding implies that one should not expect investors to begin actively trading government securities in the secondary market any time soon. Rather, the recommendations put forth mainly aim to ensure that proper market infrastructure is put in place ahead of time, so that when investors are ready to begin trading, they will be able to do so in an efficient, cost-effective manner.

Developing the Primary Market for Government Securities

The strategy for managing domestic debt should include a plan for developing the domestic debt market. The plan to conduct a market survey and consider options for dealing with nonmarketable and unrecorded debt is a good step. The analysis of the legal and regulatory framework for domestic debt issuance is also important, because this will help to identify any impediments to the efficient operation of the domestic debt market.

The process surrounding the issuance of new government securities functions fairly well in Tanzania, but there are several areas where changes could be made. For example, market efficiency could be improved by reducing the fragmentation of debt stock, settlement risk could be reduced by shortening the two-day lag between the auction and settlement, and the predictability in the auction could also be improved by reducing the uncertainty on the auction amounts.

Recommendations

- Design a strategy for developing the domestic debt market. When choosing among various strategies, one should consider the potential benefits of reducing costs and risks to the government through an aggressive expansion of government borrowing in domestic markets versus the potential for crowding out the private sector.

This strategy should also consider options for extending the yield curve for government securities through a gradual expansion of the maturities of new government debt issuance to tradable long-term government securities.

- Review the government's debt management policy and consider options for the gradual conversion of the existing stock of nontradable government securities and domestic arrears to marketable debt issues.
- The frequency of bond auctions could be reduced to perhaps one every four weeks. The same bond could be offered at three successive auctions, so that in effect four maturities are issued each year. Decisions on frequency and size of auctions should be made public in the form of an auction schedule.
- Consider shortening the settlement period for treasury bills, initially to T + 1 and eventually to same-day settlement.

In the medium term, the BoT's weekly activity in the context of pursuing monetary policy objectives will set the stage for more frequent interventions, perhaps ultimately daily interventions. This would require shortening the settlement period for treasury bills, ideally to same-day settlement. Moving treasury bills to same-day settlement would also help to reduce systemic risk in the financial system by reducing the risk that investors might not honor their obligations at the time of settlement.

- The amount of securities issued at auction should normally be the same as the amount announced in the call for tender. Rather than issue a different amount of treasury bills than originally announced, the BoT could make use of other instruments, such as repos or foreign exchange swaps, to offset any liquidity shocks that may arise after the call for tender.

Developing the Secondary Market for Government Securities

It is expected that secondary market trading will develop when general economic and market conditions become conducive, but the authorities can still play an important role in the development of secondary market transactions. Specifically, they could enhance the liquidity of government securities and affect the design of the microstructure of the secondary market by defining trading procedures in the market and promoting efficient trading systems and market transparency.

Recommendations

- In the medium term, once the demand for secondary market trading increases, the secondary market could be organized as an open-outcry call auction.
- The authorities can play an active role in the development of the trading microstructure and in enhancing price transparency. Initially, they could encourage the introduction of weekly secondary market auctions, but the frequency would need to be increased along with demand. Floor-based open-outcry call auctions could be used (see appendix 2).
- As turnover in the weekly auction increases and the market risk associated with periodic markets of low auction frequency rises, a transition to higher frequencies, and possibly to a continuous market with market makers capable of providing continuously firm two-way quotes, would be necessary. As the market develops, these auctions could also include trading in government treasury bonds.
- Make bond pricing algorithms and yield curves readily available on the BoT's website to make it easier for investors to value their holdings of government securities.

Money Market

Money market activities can develop only when banks have incentives to manage their liquidity more efficiently. The limited number of sound lending opportunities has resulted in a high level of excess liquidity at commercial banks relative to the supply of tradable securities (treasury bills). This situation has hampered the development of active trading in the interbank and broader money markets and thus the development of instruments such as repo operations between banks. However, interbank activities could be encouraged by an adequate infrastructure to support the growth of the market when other conditions in the banking system also become conducive to this growth. This includes the establishment of a legal basis for repo transactions through the introduction of a master repo agreement,

enhancement of price discovery by improving information available on interbank transactions, and efficient use of the book-entry system to support secondary market transactions.

Another important element in promoting the development of a deep and liquid money market is the design and operating modalities of the BoT's procedures for implementing monetary policy. Currently, although these are generally functioning well, there are some technical adjustments that could be made to promote a well-functioning interbank market.

Recommendations

- Encourage banks to speed up the process of formalizing a master repo agreement for interbank operations.
- Increase the frequency of the distribution of information by the BoT on interbank transactions from weekly to daily.
- When liquidity conditions permit, exclude interbank deposits from the deposit base for the purposes of calculating banks' reserve requirement at the BoT.
- Replace the Unsecured Overdraft Facility at the BoT with a short-term Lombard facility. This facility would allow banks to have unlimited access to central bank credit providing that borrowings are fully collateralized by government securities. The interest rate on this facility could be tied to the treasury bill rate plus a significant penalty (for example, 5 percentage points) to discourage use of the facility except for emergency liquidity purposes.

Central Depository System for Government Securities

The BoT has invested a considerable amount of resources in introducing the Central Depository System (CDS) and ensuring that it is supported in law. However, the benefits of the system have not been fully realized for two principal reasons. First, securities are not fungible, and, second, market knowledge about the system appears to be very low.

Recommendations

- The CDS should be upgraded to facilitate fungibility of securities by allowing the trading of securities in any size and in parcel sizes different from the size in which securities were initially issued.
- The book-entry system should be upgraded to allow securities to be transferred from one party to another in any amount and in parcel sizes different from the size in which they were first issued to facilitate the fungibility of securities.
- Advertise to all banks the available book-entry system procedures, and phase out the use of physical certificates, which currently coexist with the book-entry system.
- The BoT should ensure that participants in the book-entry system are aware of its operations and particularly its benefits. This could take the form of providing to primary dealers a set of rules governing the operation of the system, as well as providing owners of the securities lodged in the system with monthly statements of their holdings to facilitate back-office reconciliations.

I. INTRODUCTION

Public debt management is the process of establishing and executing a strategy for managing the government's debt portfolio to meet government funding requirements, achieve objectives for cost and risk, and meet any other objectives related to debt, such as promoting the development of the market for government securities. It is also important to ensure that both the level and growth of debt are fiscally sustainable.

Although unsustainable debt burdens and financial crises usually result from poor fiscal policies, the feedback goes in both directions. Poor management of the risks of debt can result in large, unexpected increases in debt-servicing burdens with negative implications for the budget and the continued debt sustainability, particularly for countries already burdened with a high debt load.

In this context, debt management needs to be carefully coordinated with macroeconomic and other public policy objectives. Coordination and sharing of information on the timing of government receipts and expenditures with monetary policy authorities also is important for enabling the central bank to efficiently manage the amount of liquidity in the financial system. Good cash management also helps to enforce budget discipline and avoid overborrowing because of excessive idle cash balances in the government's account at the central bank.

The development of an efficient market for government securities is an integral part of debt management strategy. By fostering the development of a deep and liquid debt market generally, an efficient government securities market helps to reduce the vulnerability of the economy to shocks by providing domestic borrowers with a broader range of financing sources. Also, a developed domestic debt market contributes to lowering the cost and risks of the government's own debt portfolio by increasing the menu of available funding options.

Many countries in eastern and southern Africa are implementing reforms in areas of debt management, cash management, and debt market development, as is the case in Tanzania. The purpose of this case study is to illustrate sound practice in designing and implementing such reform programs by evaluating Tanzania's practices relative to sound practice in other countries and in light of the particular circumstances in Tanzania. This evaluation is based, in part, on the *Guidelines for Public Debt Management* (2001), produced by the staffs of the International Monetary Fund (IMF) and the World Bank. Because circumstances in different countries can vary significantly, sound practice as summarized in these guidelines needs to be applied flexibly. The intention of this case study is to provide guidance to other countries in the region, many of whom are in circumstances similar to Tanzania's, to help them develop such reform programs and build capacity to implement

them. The case study is published by the World Bank and Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI) and used in their efforts to assist countries build this capacity. This is the second such case study on these topics in the region, with the first being a case study of Malawi (MEFMI 2001).

The case study covers public debt management, cash management, and debt market development to illustrate the interrelationships between these policies and the need for coordinating them.¹ It is structured into separate modules corresponding to those in the *Guidelines for Public Debt Management*. Each module contains a description of current practice in Tanzania, identifies policy issues in light of sound practice in other countries and problems with the current reform programs in these areas, and makes suggestions for how Tanzania can address these issues.

¹ For a more detailed discussion of debt market development, see World Bank (2001).

II. BACKGROUND

At the end of March 2001, Tanzania's external debt totaled US\$7.5 billion in nominal terms, including US\$1.1 billion in interest arrears (table 2.1). Arrears of principal and interest totaled US\$2.5 billion, which were largely due to bilateral, commercial, and private creditors. Excluding the arrears, roughly half of the total outstanding debt was owed to multilateral creditors, one-third to bilateral Paris Club creditors, about 10 percent to commercial and other creditors and the remainder to non-Paris Club bilateral creditors. Central government borrowings and debt issued by parastatals with the guarantee of the central government account for the bulk of the external debt. The share of the disbursed and outstanding external debt owed by the private sector was US\$298 million (5 percent of the total). Based on end-June 1999 data, about 35 percent of the external debt was denominated in Special Drawing Rights 28 percent in U.S. dollars, 11 percent in yen, and the remaining 26 percent in various other currencies.

In addition to the guaranteed external debt, there also exists a stock of on-lent loans. This stock was built up in the 1970s when the parastatals borrowed heavily with a central government guarantee. Many of these loans are in arrears, and it is likely that a substantial part of this debt will not be repaid because of the financial difficulties the parastatals are facing. The amount of the on-lent loans and the obligations that they present for the central government are currently being compiled and validated.

Table 2.1 Stock of Public Debt of Tanzania

<i>Part A External debt position by borrowers (US\$ million)</i>			
	<i>1998–99</i>	<i>1999–2000</i>	<i>March 2001</i>
Central government	6,168	6,093	5,910
Public corporations	165	183	174
Private sector	247	262	298
Total disbursed and outstanding debt	6,580	6,538	6,382
Interest arrears	1,089	1,086	1,113
<i>Part B External debt position by category of creditors (US\$ million)</i>			
	<i>1998–99</i>	<i>1999–2000</i>	<i>March 2001</i>
Multilateral creditors	3,338	3,571	3,573
Bilateral creditors	3,532	3,254	3,057
Commercial creditors	456	526	590
Other private creditors	344	273	274
Total external debt outstanding	7,670	7,624	7,494
Interest arrears	1,089	1,086	1,113
<i>Sources: Economic and Operations Report for the Year Ended 30th June, 2000, Bank of Tanzania; Annual Report on Debt Management in Tanzania 1998–99 and Public Debt Newsletter, 15th April, 2001, Ministry of Finance, Accountant General Department.</i>			

By March 31, 2001, Tanzania's domestic debt amounted to TZS (Tanzania shillings) 809 billion (US\$930 million), including principal arrears of TZS 29.5 billion (US\$34 million) (table 2.2). There are no interest arrears. The domestic debt mainly consisted of marketable debt (treasury bills and two-year treasury bonds) of TZS 298 billion (US\$344 million), nonmarketable securitized debt (long-term special bonds and stocks issued largely as a result of the privatization program) of TZS 476 billion (US\$550 million), and a variety of smaller, nonsecuritized claims (shown as "Other debt" in table 2.2) of TZS 34 billion (US\$40 million). The BoT and the commercial banks each hold 38 percent of government domestic debt, pension and social security funds hold 19 percent, and the remainder is held by small financial institutions, insurance funds, and private investors.

In addition, there is a stock of unrecorded debt outstanding that consists largely of arrears on suppliers' credits to the government that have not been paid over the years as a result of the financial constraints imposed by the cash budgeting system. The latter category

is estimated at around TZS 80 billion (US\$90 million). In addition, the continuing privatization program is likely to result in additional government debt issuance to recapitalize parastatals with negative net worth. The MoF and the Presidential Parastatal Sector Reform Commission are in the process of compiling and validating data on debt already issued for privatizations and the outstanding debt of parastatals remaining to be privatized.

Table 2.2 Domestic Debt Position by Category of Holders and by Instruments

Category of Holders	Type of Instruments								Total	Percentage	
	T-Bills		Two-Year Bonds		Special Bonds		Stocks				Other Debt
	millions of TZS	(millions of USD)	millions of TZS	(millions of USD)	millions of TZS	(millions of USD)	millions of TZS	(millions of USD)	millions of TZS	(millions of USD)	
Bank of Tanzania					85189	(98)	211749	(245)	296938	(343)	38%
Commercial Banks	94,740	(109)	38,590	(45)	159,888	(185)	1,149	(1)	294,367	(340)	38%
Non-Commercial Banks	13,008	(15)	6,827	(8)			1,661	(2)	21,496	(25)	3%
Non-Bank Financial Institutions	1,227	(1)	1,621	(2)			4	(0)	2,852	(3)	0%
Pension Funds	48,830	(56)	82,746	(96)			14,372	(17)	145,948	(169)	19%
Insurance Funds	6,699	(8)	475	(1)					7,174	(8)	1%
Private Sector	442	(1)	2,776	(3)			1,812	(2)	5,030	(6)	1%
Sub-Total	164,946	(191)	133,035	(154)	245,077	(283)	230,747	(267)	773,805	(894)	100%
Memo: Unknown Holders									34980	(40)	
Total Outstanding	164,946	(191)	133,035	(154)	245,077	(283)	230,747	(267)	34,980	(40)	808,785 (934)
Percentage	20%		16%		30%		29%		4%		100%

Source: Public Debt Newsletter, Accountant General Department, Ministry of Finance, Tanzania, Volume II 15, April 2001

ORIGINS OF THE DEBT BURDEN

The origins of Tanzania's debt burden can be traced back to inappropriate economic policies in place from the 1960s through the mid-1980s. During this period, Tanzania pursued economic and social policies under the Arusha Declaration, which emphasized socialist principles of economic management. At first, progress was made in terms of economic and social development as real gross domestic product (GDP) growth rates averaged 4.7 percent per year from 1968 to 1978. However, in the late 1970s and early 1980s, the inefficiencies of a state-controlled economy combined with unfavorable weather conditions led to a sharp decline in economic activity, severe macroeconomic imbalances, widespread shortages, and deteriorating living conditions.

With the support of the IMF, the World Bank, and bilateral donors, Tanzania embarked on a broad-based structural adjustment and stabilization program in 1986. The first two structural adjustment programs, Economic Recovery Program (1986–87, 1987–90) and Economic Recovery Program II (1991–93), were aimed at dismantling the system of state controls and promoting the private sector. As a result of these reforms, the economic indicators improved significantly, with an average GDP growth rate of 4 percent between 1986 and 1993, and the level of international reserves increased to about three months of imports of goods and nonfactor services by June 1993. However, inflation remained close to 30 percent, largely because of the central bank financing of the fiscal deficit. By the end of 1992, the government had abandoned its commitment to implement the economic reforms, and in 1993, the IMF, the World Bank, and bilateral donors suspended their financial support to Tanzania as a result of continuing deterioration in the management of the economy. The lack of expenditure control and inadequate tax administration in 1993–95 contributed to large fiscal deficits, a sharp decline in international reserves, and continuing high inflation as the government looked to the central bank to finance its fiscal deficit.

After the election in 1995, with the support of the IMF and the World Bank, the new government undertook a vast program of structural reforms and macroeconomic stabilization that led to a comprehensive reform of the tax system, privatization of parastatal enterprises, restructuring of the financial system, and streamlining of the civil service. As a result, Tanzania's economy has performed well in recent years. Real GDP growth has been rising steadily, reaching 5.1 percent in 2000, up from 4.0 percent in 1998 (table 2.3), helped by good performance in agriculture, mining, and tourism. The 12-month inflation rate declined for the fourth consecutive year, falling from 15.5 percent in December 1996 to 5.5 percent in December 2000. On the external side, improvements in the goods and services accounts and in official transfers contributed to a buildup in gross official reserves from US\$240 million at end-1996 to US\$974 million at end-2000.

The sharp increase in international reserves has strongly influenced monetary developments in recent years. In addition to continued rapid growth in foreign currency deposits, M2 grew by 15.0 percent and 12.5 percent in 1999 and 2000, respectively; in both years, net foreign assets accounted for virtually all the growth in broad money. The BoT refrained from sterilizing the associated increase in liquidity because of sluggish credit to the private sector—credit grew by only 16 percent in 2000 (compared with 36 percent and 26 percent in 1998 and 1999, respectively) after adjusting for one-time writeoffs connected with the privatization of the National Bank of Commerce (NBC). In terms of the composition of broad money, the share of foreign currency deposits increased from 18 percent at end-1998 to 22 percent at end-2000.

The increase in liquidity translated into a sharp decline in yields on domestic treasury bills. Real interest rates on three-month treasury bills approached negative levels, with nominal rates declining from about 15 percent at the beginning of 2000 to less than 5 percent at year-end. However, bank lending rates remained rigid at 18–19 percent on a weighted average basis.

Despite the considerable progress made in structural reform and macroeconomic stabilization, real per capita GDP growth rates have averaged only about 1.5 per year over the past five years, below the government's expectations. As in any economy in transition, it will take time for Tanzania to see the full benefit of the reforms in terms of per capita income growth. Nonetheless, the economy has been performing reasonably well in recent years. The growth rate of per capita income was 2.1 percent in 2000, up from 1.6 percent in 1999. The current account deficit (excluding grants) fell sharply, from 21 percent of GDP in 1994–95 to an average of about 12 percent of GDP per year in the last three years, reflecting mainly the resumption of the donors' financial assistance. The current account deficit, excluding official transfers, was 9.4 percent of GDP in 1999–2000 and 5.9 percent when the official transfers are included. Such a big reduction indicates the importance of the official transfers in the government budget financing.

Table 2.3 Tanzania: Selected Economic and Financial Indicators, 1996-2002

	1996	1997	1998	1999	2000	
					Prog.	Est.
(Annual percentage change, unless otherwise specified)						
National income and prices						
Nominal GDP (billions of Tanzania shillings)	3,768	4,703	5,711	6,526	7,246	7,263
Real GDP growth	4.5	3.5	4.0	4.8	5.2	5.1
Real GDP per capita	1.7	0.8	1.2	1.9	2.3	2.2
Consumer prices (period average)	21.0	16.1	12.8	7.9	5.6	5.9
Consumer prices (end of period)	15.5	15.4	11.3	7.0	5.0	5.5
External sector						
Export, f.o.b (in U.S. dollars)	768.0	752.6	588.4	542.8	596.2	663.1
Imports, c.i.f. (in U.S. dollars)	1,408.8	1,269.5	1,569.0	1,572.7	1,747.9	1,534.4
Export volume	17.0	-28.0	-3.4	-7.7	8.8	25.8
Import volume	3.7	10.8	11.3	1.7	3.5	4.9
Terms of trade	-0.2	14.2	-7.7	7.7	-2.2	-8.7
Nominal effective exchange rate (end of period)	0.9	5.2	-10.1	-10.5	...	9.3
Real effective exchange rate (depreciation)	15.7	19.3	-0.7	-5.6	...	12.4
Public finance 1/						
Revenue (excluding grants)	27.6	8.2	11.4	12.0	12.2	16.2
Total expenditure	7.1	19.8	17.5	32.6	8.1	11.4
Current expenditure	11.3	7.5	16.9	25.4	13.5	22.0
Development expenditure and net lending	-9.1	79.0	22.4	49.0	-5.4	-12.9
Money and credit						
Broad money	8.7	13.3	10.8	18.6	12.6	14.8
Net foreign assets	-166.1	596.0	17.0	32.2	8.6	48.1
Net domestic assets 2/	-9.4	0.1	5.6	6.6	4.0	-18.2
Credit to government 3/	5.9	-19.1	11.8	34.8	2.6	-16.2
Credit to nongovernment sector 2/	-43.0	29.5	35.7	25.5	7.1	9.4
Velocity (fiscal-year GDP/end-period M3)	4.6	5.1	5.6	5.4	5.2	5.2
Treasury bill interest rate (in percent; end of period) 4/	13.8	11.4	11.8	15.5	...	6.9
(In percent of GDP, unless otherwise indicated)						
Public finance						
Revenue (excluding grants)	13.2	13.5	11.9	11.3	11.3	11.2
Total grants	2.2	3.6	3.0	3.9	4.8	4.5
Expenditure	17.6	15.1	14.7	14.7	16.5	17.3
Overall balance (including grants; checks cleared)	-3.0	1.9	0.2	-0.8	1.1	-3.9
Domestic financing 5/	3.3	-0.7	-0.4	-0.2	0	0.1
Savings and investment						
Resource gap	-11.3	-9.7	-11.8	-11.8	-9.7	-8.5
Investment	16.5	14.7	13.3	12.8	16.0	12.7
Government	3.5	2.9	3.3	3.1	4.5	2.5
Nongovernment	13.0	11.8	10.1	9.8	11.5	10.2
Gross domestic savings	5.2	5.0	1.5	1.0	6.3	4.2
Government	...	...	...	...	...	...
Nongovernment	...	...	...	...	...	...
External sector, public debt, and debt service 6/						
Current account balance (excluding grants)	-15.9	-12.0	-13.4	-12.3	-15.9	-9.1
Current account balance (including grants)	1.5	-2.4	-5.1	-3.9	-6.9	-0.7
External debt service due, including IMF (in percent of exports of goods and nonfactor services)	45.8	37.9	39.1	34.8	25.3	30.5
(In millions of U.S. dollars, unless otherwise indicated)						
BOP current account balance (excluding grants; deficit) 6/	-941.9	-841.6	-1,322.6	-1,080.5	-1,377.6	-826.8
Overall balance of payments (deficit-) 6/	-169.3	19.3	-205.5	43.4	-53.0	56.3
Gross official reserves 6/	240.1	460.5	599.0	775.6	853.7	974.4
in months of imports of goods and nonfactor services 6/	1.5	2.8	3.5	4.2	4.2	5.6

Sources: Tanzanian authorities; and Fund staff estimates and projections.

1/ Fiscal years (July-June), beginning in the year indicated in the column header.

2/ The 1996 decline reflects loan writeoffs of T Sh 112 billion by the government-owned banks.

ENHANCED HEAVILY INDEBTED POOR COUNTRIES (HIPC) INITIATIVE

Tanzania has been classified by the IMF and the World Bank as a heavily indebted country and is eligible for enhanced HIPC debt relief assistance. As has been discussed in this study, foreign financial assistance remains an important part of the government's budget financing. Program loans and grants amounted to 23 percent of revenues in 1998–99 and have exceeded debt service payments since 1995.

In April 2000, Tanzania reached the HIPC decision point, and the IMF and International Development Association (IDA) agreed to support a comprehensive debt reduction package for Tanzania under the Enhanced HIPC Initiative. The government has also completed a Paris Club VI agreement under this initiative. Discussions with Paris Club members to reschedule or give debt relief under these terms are progressing. Discussions with non-Paris Club bilateral creditors to grant relief on Paris Club VI-equivalent terms or better were accelerated to facilitate reaching completion point for the enhanced HIPC program in 2001.

The nominal value of the central government's external debt and publicly guaranteed debt was US\$6.4 billion at the end of June 1999, the date of the data underlying the DSA used to determine the eligibility and the potential debt relief under the Enhanced HIPC Initiative. The net present value of the central government's external debt and publicly guaranteed debt as of June 1999 was estimated at US\$4.6 billion, or 397 percent of the three-year average of exports, well above the 150 percent debt threshold set by the Enhanced HIPC Initiative to determine external debt sustainability. Furthermore, the low level of per capita income in Tanzania and the vulnerability of its external position to weather conditions (agricultural crops represent about half of all commodity exports) are real constraints on the government's ability to service its debt. By any standard, the external debt level and scheduled annual debt service obligations are unsustainably high.

With the hypothetical application of original HIPC debt relief terms (Paris Club debt relief of 67 percent in present value terms plus at least comparable treatment by other bilateral and commercial creditors), it was estimated that, as of June 1999, the present value of the central government debt would be reduced from US\$4.6 billion to US\$3.7 billion. Additional debt relief under the Enhanced HIPC Initiative is estimated to total US\$2 billion in present value terms at the completion point.

The government is also pursuing other options for debt relief. On December 25, 1999, the government launched a commercial debt buyback operation supported by the IDA Debt Reduction Facility: US\$623.2 million, of which US\$324.6 million represents principal arrears and US\$298.6 million is interest arrears, of commercial debt are eligible for this debt reduction operation. Under the operation, Tanzania offered to repurchase the eligible debt for cash at the price of 12 cents for each dollar of principal. Tanzania continues to benefit also from the Multilateral Debt (Relief) Fund (MDF). The MDF includes contributions from Denmark, Finland, Ireland, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom. It provided Tanzania with funding to service multilateral debt obtained to finance

structural reforms. Finally, Tanzania is requesting bilateral creditors to go beyond the terms of Paris Club VI by forgiving 100 percent of their official development assistance credits, as agreed in the Cologne summit in June 1999.

With the enhanced HIPC assistance, Tanzania will be able to free up substantial resources to cover the government fiscal financing gap. Nonetheless, the DSA indicates that when the debt relief provided by the multilateral creditors under the full application of Enhanced HIPC Initiative terms is combined with the debt relief provided by the bilateral Paris Club creditors under the Paris Club VI agreement, the external debt-to-exports ratio of Tanzania would fall to 178 percent. If the expected writeoff of Overseas Development Administration credits were to occur, and the likely additional debt relief to be received under the other initiatives were factored in, it is projected that this ratio would be about 150 percent and would decline slowly thereafter. Although sustainable by this measure, the debt-servicing burden clearly will remain high for some time to come.

III. PUBLIC DEBT MANAGEMENT

Every government faces policy choices concerning how to manage its debt, including the sources of financing, the scope of the debt to be managed, how to manage contingent liabilities, how to coordinate debt management with other public policy objectives, and how to structure the legal authority for borrowing and the institutional arrangements for carrying out this authority. Practices differ, but there is a growing convergence in the basic principles of sound public debt management. These include:

- The importance of clear objectives for public debt management and the need for careful coordination of debt management objectives and practices with other public policies
- The benefits of transparency of debt management objectives and policies and clear accountability for achieving these objectives and implementing the policies
- The importance of a well-specified structure of governance that provides for clear authorities and responsibilities (including the legal framework and the organizational structure) and the capacity of the staff and systems within this organizational structure to carry out their responsibilities
- The need for a clear framework for evaluating alternative strategies for managing the government's debt and determining the appropriate strategy, and the importance of evaluating the costs and risks of these strategies in this evaluation and managing the risks.

DEBT MANAGEMENT OBJECTIVES AND COORDINATION

Objectives

The primary objective of debt management is to ensure that the financing needs of the government are met. Governments are also concerned with the cost of raising this financing. However, focusing entirely on minimizing costs can lead to an excessively risky debt portfolio, because there typically is a tradeoff between the cost and risk of debt. To ensure that these risks are well managed, it is important to have clear objectives for managing cost and risk. For example, many governments have explicitly specified that their primary objective is to meet the government's funding requirements at low cost, subject to an acceptable level of risk. Many governments also have included secondary objectives, such as

promoting the development of the domestic debt markets. An explicit statement of these objectives helps to ensure that the management of government debt is consistent with the government's tolerance for risk and meets other public policy objectives.

The scope of the objectives for managing debt should include all liabilities for which the government has primary responsibility, including domestic and external debt, marketable and nonmarketable debt, and concessional as well as nonconcessional debt. In many countries, this scope has broadened to include contingent liabilities, which if poorly managed can result in losses to the government and additional government debt issuance to cover these losses.

Current Practice

In the case of Tanzania, debt management objectives are implicit rather than explicit. The strategy for managing external debt could be characterized as reducing debt to sustainable levels (through debt relief under the Enhanced HIPC Initiative and a variety of other mechanisms) and exercising caution in contracting new debt to ensure that debt remains sustainable going forward. To ensure sustainability, the objective is to achieve needed external financing at minimum cost by maximizing the use of available grant financing and borrowing the rest on highly concessional terms.

Regarding domestic debt, the Tanzanian government currently has a philosophy of acquiring external funding for investment in priority areas for development and poverty alleviation. Because of the current availability of low-cost external funding and tight fiscal policy, there is at present no need for domestic funding and the policy is to issue new domestic debt only to replace debt that is maturing. Beyond this policy of rolling over maturing debt, there is currently neither a strategy nor explicit objectives for managing domestic debt. However, the government has recently launched a project to develop a strategy for managing domestic debt and integrating this with the strategy for external debt. This project includes a plan to update the DSA of external debt and conduct an integrated analysis of the fiscal sustainability of domestic and external debt. This sustainability analysis would be a central component of the new strategy for managing domestic debt. The government is also in the process of improving information and controls over contingent liabilities.

Policy Issues

At present, there are no explicit policy objectives for managing debt. Also, although there are implicit objectives for managing external debt that are contained in the government's strategy for managing this debt, this strategy effectively is based solely on cost (sustainability) considerations without consideration of risk. The project currently under way to develop a strategy for managing domestic debt is expected to lead to an integrated strategy for managing fiscal sustainability of both domestic and external debt, and this is a step in the right direction. Again, however, there is no mention of risk, and as with the current strategy for external debt, the effect will be to focus exclusively on cost without regard to risk.

In the scope of this strategy, one of the outputs of the project will be a set of proposals to better monitor and control the government’s exposure to contingent liabilities. Consequently, it is expected that the new strategy for debt management will cover the full range of liabilities the central government is responsible for—domestic and external debt and contingent liabilities.

Recommendation

The government should develop explicit objectives for debt management, including as a primary objective a consideration of both cost and risk, in addition to the objective of meeting the government’s funding requirements. The development of the domestic debt market could also be included as a secondary objective.

This should be a medium-term priority, because an explicit consideration of costs and risks will require an analysis of alternative debt strategies and building the capacity of debt management staff to carry out this analysis. Proposals for the types of analysis that are required and for developing the capacity for this analysis are discussed in the section below on the middle office.

Suggestions for developing the domestic debt market are in Chapter V.

Coordination

Government debt managers and fiscal and monetary authorities should share an understanding of the objectives of debt management, fiscal policy, and monetary policy, given the interdependencies between these objectives. Prudent management of debt, fiscal, and monetary policies can be reinforcing as fiscal discipline and low inflation lower the risk premia that need to be paid on government debt and foster the development of domestic debt markets. Prudent risk management of debt in turn reduces budgetary pressures that can result from a risky debt structure, and it lessens the risk that this poses to government deficits and the potential for future inflation.

Debt managers need to share information with the fiscal and monetary authorities on the implication for debt-servicing costs of the monetary and fiscal policies, and vice versa. For example, debt managers should inform the fiscal authorities of the cost and risk implications of government deficits, particularly if the risks of excessive borrowing could cause the debt burden to become unsustainable. At the same time, there is a need to incorporate fiscal and budget projections into the analysis of future funding needs to ensure that the debt management objectives can be met.

Information should be shared among the debt managers and the fiscal and monetary policy authorities on the government’s liquidity needs. Unexpected cash flows from

government receipts or expenditures, including those from debt issuance and repayments, can create problems for managing the liquidity in the financial system. Because monetary policy operations often involve the use of government securities, the choice of monetary policy instruments and their use can create potential conflicts with debt management objectives. When the development of the domestic markets allows, it is often advisable to use separate instruments for monetary and debt management purposes; for example, it is common for monetary policy to be conducted in secondary markets with short-term instruments, such as repurchase agreements or outright transactions involving short-term securities, and longer-term debt is issued for debt management purposes. When underdeveloped domestic debt markets require that instruments be issued at short maturities for both debt management and monetary policy purposes, there is a need for careful coordination of debt issuance to avoid conflict. It is also advisable to have separate objectives and accountabilities for monetary policy and debt management. This helps avoid potential conflict and ensures that debt managers are not taking advantage of inside information about future interest rates. When debt issuance is at short maturities for both debt management and monetary policy purposes, however, separation of objectives can be very difficult.

Current Practice

Fiscal and external debt management objectives are coordinated because of the need to ensure continued debt sustainability after achieving the needed debt relief to bring the current stock of debt to sustainable levels. Fiscal deficits are under tight control, and investments for development are limited to priority areas and must remain within the budgetary resources available. At the same time, the cost of new external funding is minimized through the policy of obtaining this external funding only through grants or on highly concessional terms. The DSA exercise also ensures a careful coordination of the analysis of monetary and fiscal policy objectives with the strategy for external debt management. The plan to conduct an integrated analysis of the fiscal sustainability of domestic and external debt also will ensure the coordination of macroeconomic policy objectives with the strategy for managing domestic debt.

The government shares information and projections of government cash flows with the BoT, and a number of steps have been taken to improve the predictability and controls over these flows. These steps include, among others, the introduction of a cash budgeting system; a new IFMS, which improved control over government expenditures; the creation of a centralized cash account at the BoT for all government ministries and agencies in Dar es Salaam, which has improved information on daily cash balances; the installation of a debt recording system (the CS-DRMS) in the MoF and training in its use, which has improved the accuracy of information from the MoF on anticipated debt servicing; and more reliable information on receipts from donors and multilateral creditors.

There is a de facto separation of the use of debt instruments for monetary policy and debt management objectives. Although the BoT also issues domestic debt for monetary policy purposes, because of the government's policy of rolling over maturing debt, all net new domestic instruments are issued to meet monetary policy objectives.

Policy Issues

The policies for fiscal, monetary, and external debt management are now being coordinated as a result of the need to maintain external debt sustainability and keep the costs of new funding low. An integrated strategy for domestic and external debt management, as envisioned in the project under way, should ensure that such coordination extends to the objectives for managing domestic debt as well. Moreover, the new debt strategy will be based on a fiscal sustainability analysis in addition to risk and cost consideration, which should ensure that the projected debt-servicing costs are sustainable and consistent with macroeconomic projections and the macroeconomic and other public policy objectives. This means that the analysis of the integrated debt strategy will have to be coordinated with monetary and fiscal policies. Such sustainability analysis is conducted infrequently, however, which runs the risk that debt management strategy will no longer be consistent if monetary and fiscal policies shift as a result of changes in the economic environment.

There have been a number of improvements in the forecasting of government cash flows and coordination between the government and the BoT in sharing information on cash balances and forecasts, and this has improved the ability of the BoT to manage the liquidity of the financial system. Even so, a number of additional improvements (discussed in detail in chapter 4) can be made.

Although a de facto separation of the use of domestic debt instruments for monetary policy and debt management now exists because of the government's policy to roll over domestic debt, this is likely to change in the future, after the government develops its policy for managing domestic debt. As long as the domestic market remains limited to short-term instruments, there will be potential for conflict between monetary policy and debt management objectives. This will be addressed in part by the government's plan to further develop the market for domestic debt instruments, which will have the effect of lengthening the maturities available on domestic debt to meet the government's financing needs. In the meantime, though, there will be a need for very careful coordination of debt issuance for the two purposes.

Regarding the separation of accountability for monetary policy and debt management, the BoT is now responsible for all elements of managing domestic debt, other than the policy of rolling over debt that has been issued for financing purposes. There is, in principle, a policy of using only the 91-day treasury bills for monetary policy purposes, with the 182- and 365-day bills reserved for government financing needs. However, because the government is not actively issuing net new debt, the BoT occasionally will issue longer-term treasury bills to smooth out the short-term yield curve on government securities. The strategy for managing the yield curve, except at the very shortest end, is usually the province of the debt manager.

Recommendations

- The capacity for analyzing domestic and external debt could be strengthened, and sustainability analysis should be carried out more frequently—at least annually. This will help to ensure the ongoing coordination between debt management policies and objectives and those of fiscal and monetary policy.
- The accuracy and timeliness of information on government cash balances and forecasts of cash flows could be improved. This will help the BoT to better manage the liquidity in the banking system. (Recommendations for making these improvements are contained in the section on cash management.)
- When circumstances permit, there should be a separation of instruments used for debt management and monetary policy, and the accountability for managing the government yield curve should be transferred from the BoT to the government. This will depend on the completion of the project to develop a strategy for domestic debt management and the pace of development of the domestic debt markets.

TRANSPARENCY AND ACCOUNTABILITY

Transparency and accountability for debt management operations and policies are important because (a) their effectiveness is improved if the objectives, strategies, and instruments are known to the public, and the government can make a credible commitment to achieving these objectives; and (b) good governance is enhanced through greater accountability of central banks, finance ministries, and other institutions involved in debt management. The two effects are self-reinforcing as good governance improves the public's confidence that the debt management objectives will be achieved and the transparency of the objectives, policies, and instruments helps ensure accountability and good governance.

Sound practice in the area of transparency includes:

- Publicly disclosing the objectives for debt management, the cost and risk measures supporting these objectives, and any secondary objectives such as domestic market development
- Publishing all material aspects of public debt management
- Regularly publishing available information on debt and the factors that affect this debt, including the budget, debt-servicing flows, the planned timing of and size of debt issuance, the financial position of the government, and so forth

- Having an open process for formulating and reporting of debt management practices.

With regard to accountability:

- The allocation of responsibilities for all aspects of debt management among the various government entities and the central bank should be publicly disclosed.
- Debt management activities should be audited annually by external auditors.

Transparency

Current Practice

The government of Tanzania already publishes a wide variety of data on debt through annual and monthly publications of the AGD. It also has published the external debt strategy and plans to publish the domestic debt strategy as the final step in the project for developing this strategy. In addition, it has launched a public campaign to build awareness of debt management issues and policies, involving civil society in setting national priorities for investment, which are then reflected in the policies for managing debt. The budget discussion and position are public information: the budget includes expected financing requirements for the coming financial year, and the auction calendar for domestic debt issuance is announced weekly.

Policy Issues

There are no policy issues at present. Tanzania exemplifies sound practice in this area.

Recommendation

No recommendations are needed. Tanzania is expected to continue its good practice in this area by publicly disclosing objectives, strategies, data on contingent liabilities, and so on as they are developed.

Accountability

Current Practice

The accountabilities for debt management and the process of decisionmaking also are publicly disclosed. They are described, for example, in the published strategy for external debt management and in the annual report of the AGD.

Policy Issues

Tanzania also exhibits sound practice in publishing information on debt management accountabilities. However, transparency and accountability would be aided by a simpler structure for decisionmaking and, to the extent possible, consolidating authority for debt management in a central unit. Many different units now have responsibility for different aspects of debt management, and decisionmaking is shared by a number of committees, with the membership comprising representatives from these various units. Spreading responsibility over a number of committees and units tends to diffuse accountability.

Recommendation

Tanzania also follows sound practice in publicly disclosing responsibilities for debt management and the decisionmaking process. However, transparency and accountability could be enhanced by streamlining this process, to the extent possible, and consolidating authority for debt management within a single unit in the MoF.

GOVERNANCE

Public debt management requires sound governance in terms of the sovereign's legal and institutional arrangements. The framework for debt management is set by legislation. The legislation defines the authority to borrow and issue new debt, and invest and undertake transactions on the government's behalf, and it establishes responsibilities, accountabilities, and controls. Precise responsibilities for managing the government's debt, along with clear reporting lines and coordination of information flows, are established according to the institutional arrangements chosen.

Legal Framework

Governments that practice sound debt management have legal frameworks that share some common elements, although the exact nature of legislation relating to public debt management may differ according to the political and institutional needs of the country. Legislation will usually specify the government's powers to borrow, invest, and enter into other financial obligations, such as guarantees, and to amortize, redeem, and repurchase government debt. It will typically contain clauses to the effect that debt is the government's direct obligation, that it is unconditionally guaranteed by the government, and that the Minister of Finance is the sole borrowing agent for the government. In addition, it will tend to establish Parliament's prerogative in approving debt issuance and will determine the precise accountability of the minister to Parliament. Important objectives of legislation are to avoid potential abuse of government power, reduce the risk of having multiple issuers of

government debt, and establish appropriate accountabilities for managing the government's debt portfolio.

Current Practice

The legal framework for public debt management in Tanzania is found in the Government Loans, Guarantees and Grants Act Number 30 of 1974, which:

- Empowers the Tanzanian Minister of Finance to raise loans and grants on behalf of the government, and establishes that where a loan has been raised by the minister on behalf of the republic, the republic is bound by the transaction
- Sets limits within which the government can borrow and specifies the limits²
- Establishes that resources from external loans be placed in a consolidated fund and that debt-servicing payments on loans or guarantees will be paid out of the consolidated fund without further appropriation (except where funding is contracted for a development project for which a special fund has been created)
- Instructs the Minister of Finance to specify, in the annual estimates of public revenue and expenditure submitted to the Parliament, the amount required for debt-servicing cost on outstanding debt during the financial year
- Empowers the Minister of Finance to issue guarantees on a loan raised externally by a parastatal organization or other corporate body, which in turn must reimburse all funds the government has paid to fulfill the guarantee
- Allows the minister to delegate to any public officer his or her functions relating to negotiating a loan and the authority to execute on behalf of the government any agreement or other instrument relating to a loan or guarantee.

A new Government Loans, Guarantees and Grants Act was drafted in 2000 and is pending approval. Some of its most important differences with respect to the former act are that it:

- Emphasizes that the authority to raise money by loan, issue guarantees, and accept grants for the republic is vested *solely* in the Minister of Finance
- Allows the minister, with the approval and consent of the lender, to prepay and restructure loans

² The limits are the total debt service cost of the next four successive years, as well as the recurrent year, should not exceed 15 percent of the average annual foreign exchange earnings of the preceding three years; and the total debt service cost of all foreign and local loans due in the recurrent year and the next four years should be less than 30 percent of the recurrent revenue of the past three years.

- Does not determine specific debt ceilings, leaving it to the Parliament to decide on the amount in any given financial year, and establishes that the Parliament will also impose ceilings on the net amount of guarantees
- Instructs the minister to include the debt-servicing costs projected for that financial year and the amount expected to be raised from loans and grants during the year in the annual budget presented to the Parliament
- Instructs the minister, during the presentation of the budget, to submit resolutions required for debt and guarantee ceilings for the Parliament's approval.

Policy Issues

Existing legislation in Tanzania already has a number of elements consistent with sound practice, and the new legislative proposal would further strengthen the existing framework. However, the government's accountability to the Parliament could be clearer. Of concern, also, is that legislation has not always been adequately enforced.

The proposed legal framework strengthens control of debt issuance in two important ways. First, by emphasizing the minister's sole authority, it reduces the possibility of unauthorized debt issuance and its many negative consequences, such as undermining the discipline of debt management, creating reputational and legal risk, and increasing exposure to fiscal difficulties. Second, the proposed legislation helps control the possibility of potential abuse of the government's power by establishing ceilings for guarantees, creating more complete information requirements by the Parliament on the amounts to be raised in the financial year, and establishing the Parliament's authorization to carry out the funding, having ensured preliminary compliance with the debt ceilings.

In addition, the proposed legislation gives greater flexibility to the government for debt prepayment and restructuring, as well as to the Parliament for establishing debt ceilings within the context of the financial year. Debt ceilings currently represent a fixed percentage of past revenues, but ideally they should be established by taking into account intertemporal circumstances, as well as updated macroeconomic analyses and DSAs.

However, the draft legislation does not specify accountability safeguards beyond the debt ceilings. The Parliament needs to verify that the powers it delegates to the Minister of Finance are being used prudently, so that debt management does not contribute to budget volatility or debt sustainability problems. This normally is ensured by requiring the minister to report to the Parliament. Although the precise nature of this reporting varies from country to country, periodic reports tend to include topics such as the main debt policies and their implementation, the nature of the debt incurred, and the risk-cost characteristics and implications of the debt portfolio.

If legislation is not properly enforced, even a sound legal framework will be ineffective. According to the MoF, in the past the framework was not always adequately administered, inasmuch as other government officials have obtained funding without the

minister's consent (United Republic of Tanzania 1999). This has put pressure on the debt ceilings and contributed to the lack of debt sustainability.

Last, Tanzania's arrears in debt servicing have generated debt-servicing uncertainty among investors, which raises the cost of debt through higher risk premia. Some countries in similar situations have included provisions in their legislation to reduce the risk of debt-servicing default by creating a permanent appropriation for all debt service. This enables the government to service debt regardless of the amounts projected in the annual budget and helps to improve creditworthiness in the eyes of local investors, international lenders, and donors.

Recommendations

- Seek better enforcement of the legal framework for public debt management and apply strong sanctions for violations. The provisions for sanctions may be contained in legislation or regulations, but in any case they must be strictly enforced to obtain the minimum discipline in the debt management process.
- Include provisions for greater accountability of the MoF to the Parliament. The Parliament has delegated to the minister the authority to incur debt on behalf of the government, and the minister should periodically (quarterly or at least annually) inform the Assembly on debt management's main policies and their implementation, as well as their budget implications.
- In the medium term, one alternative that could be analyzed to reduce debt-servicing uncertainty and improve creditworthiness in the eyes of local investors, international lenders, and donors would be the creation of a permanent appropriation for all debt service, which would enable the government to service debt regardless of the amounts forecast in the annual budget.³

Institutional Arrangements

The experience of many countries has shown the advisability of consolidating in one debt office the responsibility for managing all aspects of debt. This helps avoid duplication of functions, strengthens accountability, and reduces informational and coordination requirements. It also promotes an integrated management of the debt portfolio, which is essential for analyses of debt sustainability and financial risk.

³ However, in an HIPC debt relief context, the sovereign may enter into arrears with non-Paris Club bilateral donors until such a time as it has negotiated debt relief with that donor with HIPC-type conditions.

Countries choose different institutional locations for their consolidated debt management offices (DMOs), but generally they are found in one of three possible sites: in the MoF, in the central bank, or in an agency outside the MoF. There are points in favor of and against the different arrangements, and the final choice will be influenced by each country's particular debt management objectives and institutional characteristics:

- Centralizing debt management in the central bank can appear favorable to many countries because its staff often have higher technical skills, better pay, and lower job turnover rates than staff in the MoF. However, this arrangement can lead to a potential conflict between debt management and monetary objectives. For example, debt management decisions could be perceived as influenced by inside information on interest rate decisions. In addition, because the finance minister is responsible for debt management, the MoF will ultimately be held accountable for both debt management policy and monitoring the central bank's implementation of that policy. However, it may lack the necessary technical capacity for doing so if debt management is being carried out elsewhere and if its own institutional capacity has not been strengthened.
- Another alternative is the creation of a separate agency outside the MoF. One important reason for creating agencies has been to give debt managers the possibility of actively trading their portfolio, in which case locating the agency outside the ministry reduces the market's suspicion of inside information. Another justification has been to attract technical staff with good financial skills by paying salaries at market rates. Ultimately, however, all agencies are held accountable to the finance minister, so the same objection mentioned above would hold: MoF staff must have the technical capacity to design policies and monitor a separate agency. The agency should not design the policies and benchmarks by which it is held accountable to the MoF. Even if these guidelines were designed by third parties (for example, investment banks), they would have to be understood, approved, and monitored by ministry staff. There is no getting around the need for strengthening public debt management capacity at the MoF.
- Centralizing debt management in the MoF has a clear advantage in terms of placing the function within the entity that is politically responsible for this area of public policy. Moreover, it is easier to coordinate debt management with the rest of public policy than if the DMO were located outside the ministry. However, capacity problems may arise if the ministry's staff have low wages, low technical capacity, and high job turnover rates, as is common in many countries. In countries where skilled workers are scarce, diverting the functions into separate agencies may exacerbate the difficulties of attracting skilled staff into the MoF.

Regardless of which arrangement is chosen, sound practice in many countries shows the benefits of establishing a centralized debt unit with the sole responsibility of managing all aspects of debt and a clear specification of the organizational framework, accountability, and reporting lines.

A final related point is that where the level of financial market development allows, there should be a separation between debt management and monetary policy implementation. Clarity in the roles of and objectives for debt management and monetary policy minimizes the possibility of conflicts. Borrowing programs would be based on the economic and fiscal projections of the government budget, and monetary policy would be carried out independently from debt management. In developed financial markets, the central bank can carry out its open market operations in the secondary debt market and not compete with the government in the primary issuance.

Current Practice

In Tanzania, debt management responsibility is shared between the MoF and the central bank. It is also dispersed within the MoF itself, with no single head for debt management decisions apart from the minister him or herself. Furthermore, monetary policy is implemented through the primary issuance of treasury bills, and the MoF domestic debt issuance strategy is limited to merely rolling over the debt.

The EFD and PAD of the MoF each carry some functions of debt management. The head of each department reports to the Deputy Permanent Secretary of Policy and Financial Resources, who also has numerous other responsibilities, including the budget. Another unit with debt management functions—the AGD, in charge of debt registration, debt servicing, and statistics—is directly under the responsibility of the MoF’s Permanent Secretary, who also has many other senior-level responsibilities.

Appendix 1 gives an overview and describes the activities of the various units and committees responsible for Tanzania’s public debt management.

Currently, the main decisionmaking process of debt management in Tanzania focuses on funding. The process is divided into foreign currency and domestic currency funding decisions, although the MoF aspires to design an integrated funding strategy. The interaction of the dispersed units and the committees in the funding decisionmaking process is summarized in appendix table A1 and is discussed below.⁴

External debt funding decisionmaking. Various institutions are involved in the decisions involving external funding. The MoF has to coordinate primarily with the Planning Commission, the BoT, and the DCC.

⁴ As discussed in the section on the strategic framework and risk management, there is little decisionmaking related to risk and risk-cost tradeoffs; as such, there are no decisions made on guidelines or specific benchmarks in terms of foreign-domestic debt mix, currency mix, redemption profile, and so forth. Risk analysis is done exclusively in terms of debt sustainability, which up to now has included only the external debt. At present, there are only plans for designing a framework to evaluate contingent liabilities, such as guarantees and on-lending.

The Planning Commission advises the MoF on the external funds necessary for project implementation.⁵ Decisions regarding project selection involve prior requests from the subnational and sectoral ministries to the Planning Commission, which evaluates a project's importance in terms of national developmental priorities.⁶ Subsequently, donors and the MoF's External Debt Department reach preliminary agreements on possible funding packages, and during the Consultative Group Meeting with all donors, agreements are ratified and formalized.

The funding analysis is carried out by the PAD of the MoF with the Debt Management Department of the BoT. Currently, the MoF's external funding strategy is to first seek grant financing, then multilateral loans with the highest level of concessionality, and only then recur to other sources of concessional funding.⁷ Grant funding is not analyzed in terms of its potential impact on debt sustainability, and multilateral funding involves predetermined financial terms. Only nongrant credits that are not multilateral—which imply the possibility of negotiation of financial terms—are analyzed in terms of the loan's implications for the future cash flows of the debt portfolio and their potential impact on debt sustainability.⁸ This analysis feeds into subsequent negotiations.

Upon negotiation of more acceptable terms, the loan is presented to the DCC and a final decision is made.

Domestic debt funding decisionmaking. Because the MoF lacks a domestic debt strategy, the BoT makes most of the decisions regarding domestic debt issuance. Primary issuance policy is established at the monthly monetary policy meetings, where the MoF is represented by its Permanent Secretary and the Accountant General. Monetary targets and volumes of treasury bill issuance are set for each month. The MoF supplies information on financial requirements and external debt disbursements, and the BoT provides liquidity forecasts.

The de facto domestic debt strategy of the MoF is to roll over existing domestic debt and, to the extent possible, fund the fiscal deficit with grant or low-cost concessional external funding.

⁵ In many developing countries, external funding decisions are frequently tied to development projects (for example, as opposed to standard bond issuance for financing budget deficits); in the case of Tanzania, close to 80 percent of foreign currency funding is project linked.

⁶ The central government authorities prepare a paper on priority economic and social sectors that require funding to inform interested donors of the government's development priorities.

⁷ The policy is to not use commercial loans, although theoretically they could be used in an emergency.

⁸ This analysis is done with links to macroeconomic projections, which allow CS-DRMS to calculate risk ratios (for example, debt service to exports).

Policy Issues

Institutional arrangements for debt management in Tanzania are characterized by a high degree of functional dispersion, both between the MoF and the BoT and within the MoF itself.

In principle, the ministry is responsible for debt management policy and decisionmaking, in addition to most operational activities. Under this arrangement, the BoT's role would be limited to acting as the fiscal agent of the MoF, monitoring private sector debt and keeping the records of public debt flows required for monetary policy implementation.

In practice, however, the BoT plays a central role in public debt management. It is essentially in charge of domestic debt policy design and implementation, and the bank largely carries the load for both foreign currency and domestic debt in terms of debt registration, debt servicing, information systems, and reporting. It provides much of the technical support for the CS-DRMS. The BoT also participates in the DSAs and periodically elaborates a Debt Profile Review and other statistical studies. Finally, it is involved in functions related to foreign currency funding, such as helping the MoF evaluate funding alternatives in terms of the loan's contribution to the overall debt profile and participating in loan renegotiations.

There are two main reasons for the BoT's active role in debt management:

- First, monetary policy is implemented through primary issuance of treasury bills. This is brought about by the MoF's lack of domestic debt strategy. Occasionally, issuance is extended beyond the 91-day maturity to smooth out the yield curve, but this debt management decision is also made by the BoT's monetary policy committee. Thus, both monetary and debt management policy implementation will continue to take place in the primary market for some time to come, and it may be extremely difficult to separate the two.
- Second, the MoF lacks technical capacity in public debt management, which implies that the BoT has to duplicate many of the ministry's functions.

As a result of this dispersion of responsibilities, there is considerable functional duplication, as well as a greater need for coordination mechanisms and a continuous processing of information flows and human resources—all of which strain the institutional arrangements. The large interinstitutional committees try to compensate for this dispersion, but they also tend to diffuse accountability.⁹ A particularly negative effect of this institutional arrangement is the fragmentation of the debt management strategy. Although a policy may be

⁹ Moreover, the debt committees do not seem to be totally activated, because they are not meeting with the required regularity. In the case of the DCC, this may be due to the extreme seniority of the officials involved: the Permanent Secretary is the ministry's representative, and the Governor represents the BoT. Moreover, there are no clear reasons for the large size of the committee and why it includes members such as the Permanent Secretary of the Ministry of Justice and Constitutional Affairs and the Permanent Secretary to the Prime Minister's Office.

drawn up for a particular portion of the debt, DSA and risk analysis should deal with the aggregate debt portfolio.

A related issue is the dispersion of functions within the MoF itself, inasmuch as the MoF units described above are not consolidated into a single DMO. Experience of other countries shows the advisability of having such a unit, which is exclusively responsible for coordinating all debt management functions within the ministry.

There seems to be a tendency toward institutional consolidation and capacity building at the MoF. In the medium term, debt management functions—with the exception of fiscal agent functions—may be transferred from the central bank to the MoF. However, the decision has not been formalized and, indeed, cannot be implemented until capacity is more permanently developed at the MoF. For the time being, the two entities will continue to show a certain amount of duplication of functions and will need continuous coordination.

If debt management functions are eventually transferred to the MoF, ideally they should be consolidated in one unit, namely, a DMO with a head and deputy head exclusively responsible for all debt management functions.

However, if this ideal is impossible to implement in the near term, an alternative would be to create stronger coordinating mechanisms within the ministry (for example, an internal MoF debt committee, periodic meetings and reports between the units, and so on). The internal debt committee would have the participation of staff from the various units involved with debt management, including the PAD, the EFD, and the AGD, and possibly the Budget Department. This committee would help the minister address strategic debt issues and specifically deal with the cost-risk dimensions of the portfolio, as well as reinforce the operational coordination of debt management at the MoF. However, this is still a second-best solution because committees tend to disperse accountability, and most of the final responsibility would still fall to the Deputy Permanent Secretary of Policy and Financial Resources, who has multiple responsibilities in addition to debt management.

Finally, it is probable that monetary policy will continue to be implemented through the primary market for some time, with the MoF also issuing in the same market to fund a portion of its budgetary needs. Nonetheless, MoF debt managers can at a minimum develop a domestic market debt strategy¹⁰ and give their input to decisions on primary issuance, even if some conflict may arise with the BoT on aspects such as preannouncing auctions, defining issue size, and so forth. The MoF and the BoT can negotiate their preferences for achieving their different objectives, and there may be opportunities to accommodate their respective needs. Close coordination is highly desirable (for example, to avoid issuance at the same time in the same market segment).

¹⁰ The MoF has recently begun a project to develop a strategy for domestic debt management.

Recommendations

- Centralize and consolidate debt management responsibilities to the extent possible. If debt management functions are eventually centralized at the MoF, then ideally they should be consolidated in one unit, namely, the DMO. If this is impossible in the near term, an alternative is to create a stronger coordinating mechanism within the ministry, such as an internal debt committee. A full transfer of responsibilities from the central bank to the MoF cannot be implemented until capacity is developed on a more permanent basis at the MoF.
- Improve coordination of monetary and debt management policy. Although for the time being, monetary policy in Tanzania will continue to be implemented through the primary market, debt managers at the MoF can develop a domestic market debt strategy and provide their inputs to decisions on primary issuance. The MoF and the BoT can negotiate their preferences for achieving their different objectives, and there may be opportunities to accommodate their respective needs. A written agreement between the MoF and BoT would help clarify the responsibilities and improve institutional coordination.
- Active committees for institutional coordination are needed. Regardless of whether a DMO is consolidated or not, the nature of the funding process in Tanzania involves a sufficiently high number of entities external to the ministry, which merits a greater activation of the debt management committees with strict enforcement of the regularity of the meetings. The list of committee participants may need a review, because some do not appear to have a direct involvement with the debt management process.

Structure of Debt Management Operations

Public debt management involves not only financial market exposure—currency, interest rate, and refinancing risk—but also significant operational exposure. Failure to correctly implement a funding transaction, service the debt, register debt contracts, or maintain exact and updated debt statistics can have costly implications for a government. Thus, to systematically address and manage the various types of risks inherent in the day-to-day management of the debt, authorities should ensure a sound operational culture.

An organizational structure with functional divisions among the funding, analytical, and debt registration and servicing activities is essential for promoting operational accountability and control. Sound-practice DMOs are usually divided into front, middle, and back office units, which have distinct objectives, functions, and responsibilities, as well as separate reporting lines. Each unit has specialized technical knowledge and tools. A brief description of the three units follows, although these topics will be explained in greater detail in subsequent sections.

- The front office is typically responsible for all funding transactions, including external loan negotiations and domestic government debt auctions. In this process, front office staff seek the most efficient funding cost, taking into account the risk parameters established by senior management.
- The middle office undertakes the analytical functions that enable senior management to choose a debt management strategy; it also monitors the front office's performance in terms of compliance with the chosen strategy and established risk limits. (These two types of responsibilities are sometimes separated into two subunits.)
- The back office handles transaction confirmations, settlements, and payments, and it maintains records of new contracts, disbursements, payments, debt restructuring, on-lending, and so forth.

The front and middle office separation helps to ensure the independence of staff that design debt strategy (especially with regard to risk preferences) from staff executing the transactions. In addition, middle office independence enables it to monitor the front office's transactions to ensure that they are being implemented within approved guidelines.

In turn, the front and back office separation ensures that transaction confirmation, servicing, and transfers are carried out by staff different from that in charge of funding, thus avoiding potential misuse by front office staff of the capacity to carry out transactions.

Finally, it is important to emphasize a necessary condition for debt management in each of these three units, namely, the need for staff with adequate technical capacity. It cannot be sufficiently stressed that sound public debt management requires staff with a good combination of financial, macroeconomic, and public policy skills. The ability to recruit and retain highly skilled debt management staff is absolutely crucial for mitigating both policy and operational risk.

Unfortunately, staff capacity is relatively weak in the MoF of Tanzania and seems to be an important factor influencing its limited role and the duplication of its functions by the BoT. Some units in the MoF are understaffed in relation to their authorized number of employees, and, in general, technical capacity is relatively low and turnover is high. This is largely a reflection of the low civil-service remuneration of MoF staff relative to their counterparts in the private sector and the BoT.

As a result of low pay and insufficient training incentives, the MoF has difficulties recruiting and maintaining qualified staff. Young graduates from the universities and training institutes may join the ministry, stay for one year to receive training (information technology is especially popular), and then leave for a better remunerated job elsewhere.¹¹

¹¹ For example, in the External Debt Department, only 14 of 26 authorized staff positions were filled at the time of this study. This is partly the result of a freeze on new hires, but it is also due to lack of motivation and high

A civil service reform program was designed to improve civil service conditions, and its recommendations included organizational and efficiency reviews, pay reform, retrenchment and redeployment, and strengthening local government. However, with the exception of the first year (2000), budgetary restrictions limited the implementation of the five-year program.

There have been recent efforts to upgrade capacity in the MoF (for example, with newly graduated hires for the AGD). To retain staff, however, it has been necessary to rely partly on donor funding for wage increases to staff, but even then, these increases are for only a limited number of technical staff. To strengthen its technical capacity, the AGD is currently making arrangements for two- and three-year secondments from the BoT. There have been other types of compensatory solutions within the civil service, such as the creation of the TRA as a special and separate administrative unit with higher salaries; however, there is the risk that the special funding may run out without having strengthened capacity in the mainstream public sector.

Recommendations

- Provide better remuneration and benefits for public debt managers at the MoF. Sound public debt management requires staff with a good combination of financial market skills and public policy skills. The ability to attract and retain highly skilled debt management staff is absolutely crucial for mitigating both policy and operational risk.
- If there is an intention to eventually transfer most of the debt management functions from the BoT to the MoF, then a more comprehensive approach to salary upgrades and benefits is needed to permanently strengthen long-term capacity for public debt management in the MoF. This should include a training budget, which is of great significance to staff and which may help to compensate the relatively low level of salaries in comparison with those of the central bank and private sector, as seen in other countries. In addition, numerical staffing needs should be met by filling authorized positions; this, however, probably depends on civil service reform.

Front Office Functions

The main objective of the FO is to raise funding for the government at the minimum cost, subject to an acceptable level of risk as defined by senior policy makers.

staff turnover, with many employees leaving for the BoT. Donor-supported workshops are now almost nonexistent, and ministry-funded training is limited because of budgetary restrictions.

Institutional arrangements. Ideally, funding and hedging functions should be consolidated in a single FO unit. In many developing countries, however, these functions tend to be dispersed among different units of a country's MoF, central bank, and ministry of planning.

The FO of the MoF would normally be in charge of the external borrowing process in consultation with sector ministries and the planning ministry. To be more efficient, the FO of the MoF would also execute the strategy for domestic funding, and the operational side of the domestic currency funding would be undertaken by the central bank on behalf of the MoF. A joint committee or consultation process on cash forecasting, involving the MoF and the central bank, would often determine the amounts of domestic borrowing to be auctioned. If the two entities were operating in the same segment of the primary market, joint decisions would usually be made on new domestic funding instruments, because these could affect both funding costs for the government and the monetary policy objectives of the central bank.

Conformity with the legal and regulatory framework. The FO should operate within a legal and regulatory borrowing and issuance framework that instills confidence and protects investors, creditors, and rating agencies. Normally, an act of parliament authorizes the minister of finance or the minister's nominee to contract finances through borrowing or grants, as well as issue government guarantees on behalf of the state.

The FO should adhere to government debt guidelines and strategy and should also adhere to systems and procedures that ensure that the government's funding and risk management activities are conducted in a timely and transparent manner.

Interaction with funding sources. It is the responsibility of the FO to maintain well-informed and coordinated relations between the government and the markets, investors, credit-rating agencies, and international creditors. The FO usually plays an important role of liaising with the country's donors or development partners. It also interacts with the domestic financial markets through auctions of government funding and through coordinated relations that give greater transparency and predictability to the market. Marketing road shows and periodic reports of the country's debt and risk management strategies, funding needs, and development priorities help increase stakeholder awareness while promoting transparency and confidence.

Evaluation of funding alternatives. The FO should be able to evaluate funding prospects and their impact on the debt portfolio in terms of compliance with the approved strategy. Evaluations should be made of the technical, financial, and legal terms and conditionalities of external loan proposals, including the loan purpose, conditions for disbursing the loans, and the degree of concessionality. The minimum grant element or level of concessionality may be set at specific levels, such as IDA terms for IDA-only borrower countries.

Negotiation of funding. An FO should be able to negotiate with all external creditors and issue the desired amount and type of borrowing or hedging instruments in the international financial markets. For domestic debt issuance, the central bank should execute the domestic borrowing program according to the government's objectives.

If the country concerned is restricted to borrowing on IDA-only terms, much of the external funding would be supplied by multilateral and bilateral donors. The FO would review and negotiate, as far as possible, proposed loan terms and evaluate costs, conditionalities, concessionality, availability of technical assistance, and the total financing packages. However, terms and conditions for most concessional funding programs are usually standard, leaving limited room for negotiation.

Compliance with middle office guidelines. FO activities need to conform to the parameters of the medium- and long-term debt management strategy as recommended by the middle office and approved by policymakers. The FO would correspondingly adjust the borrowing mix to the recommended guidelines (by domestic or external funding source or both); instruments to be issued, redeemed, or rolled over; and the borrowing currencies, interest rates, maturities, and debt-servicing profiles that could help avoid a lumping of maturities.

FO Current Practice

The Tanzanian authorities have made considerable progress in many of these FO functions.

Institutional arrangements. Because Tanzania lacks a centralized debt management department, FO activities are shared among various coordinated departments in the MoF, Planning Commission, and BoT:

- The BoT's Financial Markets Department interacts with the domestic financial markets for fiscal funding.
- Through a consultative process for monthly government cash forecasting and recommendations of the Monetary Policy Committee (MPC), the BoT's Directorate of Economic Policy conducts the analysis that determines the domestic borrowing requirements and levels.
- The ministry's EFD and PAD, as well as the Planning Commission and, occasionally, sector ministries, are involved in external funding activities. After a review of projects in terms of their national importance by the Planning Commission, the EFD coordinates and contacts external funding sources, which are predominantly bilateral and multilateral donors. When sector ministries need to borrow after the budget process has been concluded, they are required to identify and negotiate external funding sources for their proposed additional projects.
- The DMC, which has senior-level representation from the MoF, BoT, and Planning Commission, coordinates and oversees all external funding, in line with the External Debt Strategy of 1999. The PAD handles the debt strategy and analysis functions. The Budget Department and the PAD determine the external borrowing requirements for the budget.

- Civil society is consulted in the formulation of the external debt strategy. However, they are not directly involved in FO activities.

Legal and regulatory framework. The Government Loans, Guarantees and Grants Act Number 30 of 1974 empowers the Minister of Finance, or any other official he or she may nominate, to raise, negotiate, or restructure external and local loans, guarantees, and grants. The minister's authority is restricted to contracting financing within stipulated ceilings. FO operations undertaken by the BoT in domestic debt markets also take place within the context of the powers given to the minister.

The 1974 act was reviewed, and a draft has been prepared for Parliament's authorization. The enforcement of borrowing limits enunciated in the act was to be improved through issuance of clearance or nonclearance certificates for new loans by the Paymaster General.

All external borrowing and negotiations are guided by the document of Tanzania's National External Debt Strategy of March 1999. With respect to guarantees, the document requires pledging of borrowers' assets, and it also requires that projects fall under agreed national priority areas. Currently, the government is not issuing new guarantees to parastatals.

The Attorney General's Department handles the legal aspects of FO activities, as well as any legal disputes related to government loans and guarantees.

Interaction with funding sources. For FO external debt functions, the EFD has the mandate to interact with Tanzania's development partners and coordinate donor support. However, sector ministries and parastatals may also contact and negotiate directly with identified financiers for projects additional to those approved and incorporated in the budget framework.

The BoT's Financial Markets Department has the responsibility for interacting with domestic financial markets.

Evaluation of funding alternatives. The EFD, in consultation with the PAD and the BoT's Debt Department, conducts the financial analysis of the terms and conditions of loan proposals before their signing. At the request of the MoF, the BoT's Debt Department evaluates loan concessionality, grant element, and alternative terms using management tools in the CS-DRMS.

Feasibility studies for donor-funded projects are undertaken by the EFD, the sector ministry that provides technical analysis, and the donors. This facilitates a cost-benefit analysis of the projects.

For domestic borrowing activities, the level and instruments to be issued are recommended by the MPC for execution by the BoT's Financial Markets Department. The

Financial Markets Department and the BoT's Directorate for Economic Policy are responsible for conducting the evaluation of funding alternatives of the domestic financial markets.

Negotiation of funding. The EFD is in charge of negotiations with external donors at both bilateral and multilateral levels. However, for projects additional to those already in the budget frame, sector ministries and parastatals are required to identify and negotiate with financiers. The MoF's PAD takes the lead in negotiation of debt reorganization and restructuring through the Paris Club and the HIPC Initiative.

Compliance with middle office guidelines. By evaluating the national importance and priority of project proposals, the Planning Commission performs a middle office function that has to be conducted before negotiating with the donors.

Given that the Government Loans, Guarantees and Grants Act Number 30 of 1974 is an old piece of legislation, it is most likely that its borrowing ceilings have become obsolete. The parameters outlined in the External Debt Strategy of 1999, which the EFD adheres to, would probably be up to date for guiding external current and future borrowings.

FO Policy Issues

Tanzania lacks a centralized debt management department, and FO activities are shared among various departments, which raises the issues of coordination of various functions of the FO among the institutions and departments involved. Committees are one way to address the coordination of FO functions, but ideally a more permanent solution would be to establish a consolidated DMO.

For domestic borrowing, the BoT Financial Markets Department has the responsibility for issuance of domestic debt instruments. However, line ministries have in the past directly contracted nonsecuritized debt through accumulation of domestic arrears or suppliers' credits. Measures have since been taken by the MoF to stop this practice under the cash budget system.

The 1974 act is out of date, and its revision is necessary for updating FO functions.¹² It is also necessary for the MoF to design a domestic debt strategy; otherwise, primary debt issuance in the domestic market will continue to be dominated by monetary policy implementation.

The EFD may have experience and expertise in loan and grant negotiation, but this may not necessarily be the case for the sector ministries and parastatals, who are required to identify funding and negotiate directly with financiers for additional projects above those approved and incorporated into the budget frame.

¹² The 1974 act was being reviewed at the time of this study, and this should help bring its provisions in line with more recent developments in the socioeconomic situation of Tanzania.

Project follow-up, although necessary, is constrained by lack of human and financial resources. This affects the disbursement rates for donor-funded projects and can increase the risk of accumulating undisbursed balances in the debt portfolio.

The wide geographic distribution of projects increases project monitoring and auditing costs. More concerted use could be made of regional centers to assist in monitoring project implementation to avoid disruptions in the disbursements of donor-funded projects.

Recommendations

- Promote the consolidation of FO functions into one unit, or at a minimum strengthen coordination among the units involved in FO activities.

Given the level of expertise required in dealing with donors, it is important to maintain a single contact point for negotiations with donors. Therefore, the MoF's EFD may need to help sector ministries and parastatals by leading the identification of and negotiation with potential donors. In addition, the EFD can be more involved in loan renegotiations, if this is deemed appropriate for integration of the negotiation function.

It is important that project appraisal by the Planning Commission in light of national priorities be adhered to in all cases before entering into any commitments with the financiers or beneficiaries. Speedier appraisal of projects and related funding could encourage sector ministries to follow through the entire evaluation process.

The requirement that all projects earmarked for donor funding should be first assessed for national importance by the Planning Commission is important in the analysis done before contracting loans, and it should be continued.

- Continue efforts to prepare a domestic debt strategy covering domestic debt and contingent liabilities. This will help guide domestic borrowing, consistent with the new Loans, Guarantees and Grants Act and fiscal and monetary policy objectives and targets.
- Ensure that the proposed new Loans, Guarantees and Grants Act incorporates guidelines set in the External Debt Strategy of 1999 for consistency between the two documents.

The proposed new act will need to be synchronized with the loan evaluation approach contained in the External Debt Strategy of 1999.

The parameters set in the External Debt Strategy document may not be legally binding. Once it is completed and approved, the new Loans, Guarantees and Grants Act could specifically refer to the External Debt Strategy and the Domestic Debt Strategy as legally binding documents, to be read in conjunction with the act itself.

- Although involving civil society organizations in the institutional framework for debt management may pose special challenges, it is important to routinely make available to them information on the level, terms, and purposes of government borrowing.

Recommendations (cont'd)

- It is critical to put in place ongoing staff training programs and retention strategies that help reduce staff turnover and improve motivation, particularly in the MoF. Secondment of staff from the BoT and seeking donor support in topping up salaries of critical staff are some interim measures that could be taken until longer-term solutions to improve remuneration and motivation are found.

Middle Office Functions

The main objective of the middle office (MO) is to carry out the analytical work required for strategic debt management and risk monitoring and control. This analysis enables senior management to evaluate cost and risk tradeoffs and other factors, such as the development of the domestic debt market, in choosing a debt management strategy. The MO also monitors the FO's compliance with the chosen strategy and established risk limits, such as the permissible degree of deviation from specific benchmarks.

MO Current Practice

MO functions are divided among two institutions: the PAD of the MoF and the Debt Management Department and Economic Policy Directorate of the BoT. This arrangement, which has some functional duplication, is explained by the relatively weaker technical capacity of MoF staff and the BoT's implementation of monetary policy by way of primary issuance of government securities.

Current MO analyses include:

- Strategy for external debt funding
- Policy for domestic debt issuance, albeit from the perspective of monetary policy implementation (BoT)
- DSA for external debt
- Debt profile review
- Evaluation of concessional loans in terms of their contribution to debt sustainability ratios, using CS-DRMS cash flow projections for the aggregate debt portfolio.

In addition, there are near- and medium-term plans to develop analyses of:

- Debt sustainability, including domestic debt

- Domestic debt strategy from a debt management perspective, which would also include such contingent liabilities as guarantees and on-lending to parastatals.

MO Policy Issues

There are important advances in the analytical work being done on public debt management, and equally important future activities have been programmed for the near and medium term. This will contribute to the public debt being managed in a more strategic and sustainable fashion. However, there are still multiple challenges that need to be resolved, though this can only be done gradually and in pace with the strengthening of the staff's technical capacity.

The DSA is out of date and incomplete because it excludes domestic debt. DSA is a central element in debt management for a post-HIPC Initiative country wishing to maintain its debt at a sustainable level, thus this evaluation should be periodically carried out by the MoF. Outside agencies, such as MEFMI, may continue to provide assistance, but eventually the MoF should be able to implement this analysis independently, albeit in coordination with the macroeconomic units of the MoF and BoT. It is essential that the analysis include both external and domestic debt. Moreover, debt sustainability is currently being analyzed in terms of simple ratios, but a more complete analysis would involve scenario simulation, with both deterministic scenarios and stochastic exercises.

The funding strategies that have already been designed do not incorporate risk in a systematic and quantifiable manner. Cash flow models should be used for this kind of analysis, based on projections of debt-servicing costs and amortizations of both the existing debt portfolio and future financing requirements. These models project base case scenarios for debt servicing in the medium term, as well as risk scenarios under different assumptions of currency and interest rate volatility. Sensitivity analysis enables the quantification of risk in terms of the volatility of debt service cash flows.

The CS-DRMS works on a loan-by-loan basis, which may make it tedious for MO staff to analyze different aggregate portfolio structures under a number of different scenarios. Consequently, it could also be difficult for MO staff to make the analyses necessary for the proposal of basic debt management targets, including currency composition or amortization profile.

Sensitivity analysis is lacking in debt-servicing projections, thus MO staff are unable to periodically inform the macroeconomic programming units in the MoF and BoT of the impact of differing debt-servicing scenarios on fiscal and monetary variables, including future fiscal revenues and expenditures, the inflation rate, and the balance of payments. Likewise, macroeconomic programming under varying scenarios (growth, savings, inflation targets, and so on) should be regularly incorporated into the projected debt-servicing analysis.

A central policy issue is that of strengthening the MO financial technical capacity of MoF staff, enabling them to improve the analytical work required for strategic debt

management, as well as risk monitoring and control. Salary increases and a budget for training are essential for maintaining staff and building capacity.

A training program could be designed and delivered, possibly with help from entities such as MEFMI, the African Development Bank, and the International Bank for Reconstruction and Development, that will cover MO responsibilities. Such a program should include the analytical framework of public debt management, typical risk indicators, definitions of risk and cost, the use of cash flow modeling and construction of strategic debt portfolio benchmarks, the experience of other countries in consolidating MO functions, and MO organizational arrangements and issues. There may also be a need to review financial mathematics.

Recommendations

- To strengthen the technical capacity of the MO staff, especially staff at the MoF, by improving remuneration and providing training opportunities to retain trained staff.
- The MoF should periodically carry out DSA and include both foreign and domestic currency debt in the analysis.
- Introduce the risk dimension into debt strategy by extending the DSA beyond simple ratio analysis to more complete scenario analysis.

In the medium term, the risk analysis should develop from a simple deterministic set of currency and interest rate scenarios to a more stochastic exercise, and it should be used to evaluate different funding strategies in terms of their cost and risk dimensions. This would enable the MoF to decide on the level of debt service volatility that can be tolerated in return for a lower cost of debt. Specific training can be obtained for this kind of evaluation.

The CS-DRMS should be supplemented with software, such as DSM+ or DebtPro, that will simplify the analysis by allowing an evaluation more along the lines of a portfolio. A formalized link already exists between the CS-DRMS and DSM+, so this could be a possibility to consider.

- Based on sensitivity analyses, MO staff could periodically inform the macroeconomic programming units in the MoF and BoT of the impact of differing debt-servicing scenarios on fiscal and monetary variables. Likewise, macroeconomic programming under varying scenarios should be regularly incorporated into the projected debt-servicing analysis.

This type of analysis would enable the MoF to propose some basic targets, such as the external-internal debt mix (in terms of cost and risk and taking into account macroeconomic policy directives as well as funding constraints) and desired amortization profiles. Although there are certain limitations in the concessional funding with regard to currency and interest rates, scenario analysis could be carried out by MO staff to quantify risk for the government in terms of the relation of an increase in debt servicing relative to the budget.

- The MO can act as the secretariat for the debt committees (DCC and DMC) by preparing periodic reports on the debt portfolio and proposed strategic guidelines, which are ultimately to be chosen and authorized by the minister.

MO staff should inform other interested parties—such as the Parliament, bilateral donors, and HIPC Initiative officials—of the state of the debt portfolio with reference to the approved strategy, explaining the risk-cost tradeoffs chosen by the government.

Back Office Functions

The objective of the back office is to maintain a high-quality, updated database of the debt portfolio. This allows for timely availability of debt data for policy analysis, debt servicing, and accounting.

The primary responsibilities of the back office include:

- Registration of central government loans, guaranteed parastatal and local government loans, and contingent liabilities
- Monitoring disbursements of the registered loans for purposes of updating the database
- Providing timely projections to ensure prompt and timely debt servicing
- Maintaining a debt database
- Validating debt data.

Back office functions need to be coordinated with those of both the FO and MO to ensure a transparent and timely flow of information. The back office should be able to generate consolidated reports as an essential input into the country's debt policy formulation process.

Back Office Current Practice

Until 1986, there was no computerized debt database in Tanzania. Information on debt was kept manually in different units in the MoF, and the BoT kept a register of debt service payments arising from instructions originated from the MoF.

With the assistance of the Commonwealth Secretariat (COMSEC), the government embarked on the computerization of its debt database using CS-DRMS software. It was mutually agreed by the MoF and the BoT that the latter would be responsible for recording external loans and the former would record grants. With the support of COMSEC, the BoT created a debt database in the CS-DRMS for all government and government-guaranteed loans.

The BoT obtains copies of loan agreements from the MoF as the primary source of information for recording debt and also uses disbursement notices that are copied to the BoT. At times, information is requested directly from creditors. For domestic debt, the BoT obtains the information from its Domestic Markets Department.

Since 1997, efforts have been geared toward creating a debt database in the AGD in the MoF, so that the government would have its own database without having to rely on the BoT. Staff from the AGD meet with their counterparts in the Debt Department of the BoT from time to time to ensure that the two databases are reconciled.

However, the domestic debt databases of both the BoT and the AGD are incomplete. Although the BoT records stocks and bonds in the CS-DRMS, its database excludes treasury bills. Likewise, the AGD records treasury bills in the CS-DRMS, but stocks and bonds are registered in spreadsheets.

External loan disbursements are recorded by both the Debt Department of the BoT and the AGD. When multilateral institutions are involved, the BoT obtains disbursement data directly from creditors; for other creditors, the information is sourced from the MoF.

Procedures for servicing public debt. The Foreign Markets Department of the BoT is responsible for externalizing payments on due dates once it has received payment instructions from the AGD, based on the latter's debt service projections. Payments are made after both the BoT and the AGD are satisfied that the payment is genuine and in conformity with priorities agreed upon at the beginning of the financial year. Mistakes in debt servicing—either overpayment or delayed payments—have been minimized because of strict payment verification. When there is doubt, payment is delayed until all verification methods have been exhausted.

As domestic debt is recorded in different formats in the BoT and in the AGD, the data available at any one time from a single institution are incomplete and do not allow rigorous analysis for input into the policy formulation process. Likewise, the database, at both the BoT and the MoF, does not include contingent liabilities.

Data validation. Both the Debt Department in the BoT and the AGD update the database regularly and in close collaboration. However, some disagreements still exist between the two units on the accuracy of the database. The validation exercise is further complicated by the shortage of skilled staff in the AGD, especially during 2000–01, when the unit lost approximately half its staff to the private sector and other institutions.

Staff recruitment and training. Using Swedish International Development Agency funding, the AGD was able to recruit academically qualified staff and train them in various aspects of debt management. This included in-house training, as well as external training in and outside the country. Staff retention was also promoted by salary “top ups to compensate for low government wages. However, most AGD staff left in search of better work conditions, so efforts are in place to recruit new employees and train those who are already there.

Staff in the Debt Department of BoT have been working on debt management for a number of years. They have received intensive training in different aspects of debt management and have better salaries than their counterparts in the MoF. As a result, staff turnover is not a problem in the BoT.

Back Office Policy Issues

Current procedures for registering external loans involve two institutions that both manage a debt database using the CS-DRMS. This duplication of efforts results in delays of new loan registration and even transactions.

In the past, a number of projects have experienced delays in the disbursement of funds, mainly because of the government's failure to meet cash cover requirements. This conditionality has been removed in new contracts, but delays are still experienced in getting information on disbursements when such disbursements are in the form of equipment or services or are made directly to projects.

Ensuring accurate and timely servicing of debt is crucial—not only for purposes of maintaining good credit, but also for effectively managing government cash flows. The current situation is such that the AGD relies on payment claims from creditors.

The domestic debt database is incomplete at both the BoT and the MoF—the ideal is to have only one complete and updated database.

Although the back office regularly validates its database, it is done on an ad hoc basis. There is a serious problem of staff motivation, largely because of low remuneration. Salaries for government officials are said to be very low, and this results in high staff turnover. In one year alone, back office turnover was 50 percent. Foreign donors have provided funds for topping up salaries of civil servants in specified departments, including the AGD. However, this is unsustainable in the long run.

Recommendations

- Develop a shared network link between the MoF and the BoT so that the external database is not duplicated. Given the desire of the government to have the responsibility for the debt data, arrangements should be made to allow only a few key individuals to access the database and make changes. This could be done in the near term.
- Because the domestic debt database is incomplete at both the BoT and the MoF, arrangements should be in place to allow for one site where a comprehensive domestic debt database will be maintained and regularly available for analytical purposes. This can be done in the new CS-DRMS 2000+, which can record all domestic debt instruments. To speed up the process, an institution should be made responsible for this task. At a later stage, the information could be accessed by both the BoT and the MoF through an electronic link, as would be the case with the external debt database.
- Continue to negotiate with donors to reach an agreement that would allow quarterly submission of reports to provide information for updating data on disbursements.
- Develop good internal controls that would automatically identify discrepancies in loan transactions and allow accurate and timely servicing of the debt.

There is a need to develop a timetable that specifies the frequency with which database validation should take place, including joint exercises between the AGD and the BoT. Guidelines for data validation should be made available to relevant staff to help them conduct the exercise with more precision.

- The work environment in terms of office space and working tools is of good quality, but remuneration is a major problem. The government should look for better alternatives, including improvement of the pay packages of all civil-service employees.

In the short to medium term, it may be possible for the government to motivate staff by recognizing their capabilities and minimizing the use of external consultants in assignments that can be done by local staff.

The BoT does have experienced staff who have been through the MEFMI Fellows program and are quite conversant with the CS-DRMS and procedures for loan interpretations, data validation, and simple analysis of the debt portfolio. Arrangements should be made for these employees to provide in-house training to newly recruited staff in the MoF. In addition, a well-articulated training program that is relevant to the day-to-day functions of the back office needs to be developed and funded appropriately.

STRATEGIC FRAMEWORK AND RISK MANAGEMENT

The heart of sound practice in public debt management is the development of a strategy for managing the government's debt to meet its funding requirements, achieve its cost and risk objectives, and meet other objectives the government may have, such as developing the domestic debt markets and promoting the efficiency and liquidity of the markets for government securities. In the broader macroeconomic context, it is also imperative to maintain debt at sustainable levels, to ensure that it does not pose undue risks to the budget or to broader fiscal and monetary policy objectives.

A growing number of countries with long experience in public debt management base their strategy for managing debt on an explicit cost-risk analysis of alternative choices for new debt issuance. When issuing debt, governments need to decide such things as the share of domestic to external debt, the maturity composition of domestic debt, the level of debt as determined by alternative fiscal policies, and so forth. These countries base such cost-risk analysis on the projected debt-servicing flows under a variety of different strategies for these choices, and they assess these costs and risks in terms of their projected impact on the budget, taxes, government spending programs, or other such fiscal indicators.

Models used for assessing the cost-risk tradeoffs of alternative debt strategies range from simple scenario analysis of projected debt-servicing costs that assume alternative scenarios of future interest and exchange rates, to more complex simulation models. (Such techniques are described in more detail in the section on MO functions.) When starting out, it is best to begin with simple scenario models and move to more complex models as capacity is developed. Much of this analysis can be done using the tools in the CS-DRMS, and it can be supplemented with the scenario simulation capabilities of DSM+ or DebtPro software and the monetary programming model currently in use at the BoT. Familiarity with the use of these systems is an inherent part of DSA, and the extension to cost-risk analysis using these tools is fairly straightforward. There are also more specialized models that simplify the simulation of interest and exchange rate scenarios, which can be used for stochastic simulation. Some of these models are based on spreadsheets and are relatively simple to use. Use of the existing tools for cost-risk analysis should be mastered first, and a more specialized model can be added later.

Typically there are tradeoffs between the costs and risks of alternative debt strategies. For example, the cost of short-term debt normally is lower than the cost of fixed-rate, long-term debt, but short-term debt has higher interest rate and rollover risk. Consequently, governments need to choose between lower-cost but higher-risk debt strategies and higher-cost but lower-risk strategies. This choice should be based on judgments concerning the fiscal benefits of lower-cost debt versus the higher risks posed to the budget and macroeconomic and other public policy objectives. (For countries such as Tanzania with an already high debt burden, there is substantial risk to debt sustainability of large increases in debt servicing that could result from an excessively risky debt structure. Consequently, the emphasis when choosing a debt strategy should be on minimizing risk rather than cost, and,

with a risky debt structure, the level of debt should be maintained at lower levels to ensure sustainability.) The approved strategy can then be translated into specific targets or guidelines for such things as the share of domestic versus external debt, the maturity profile of domestic debt, and other risk indicators. These targets can then be used to guide future debt issuance, in much the same way the existing guideline on concessionality is used now to guide approval of external credits. Once an integrated cost-risk analysis has been completed, similar guidelines can be issued for domestic debt as well as for the share of domestic versus external debt.

Current Practice

The government of Tanzania published a strategy for managing its external debt in 1999 (United Republic of Tanzania 1999) and has recently begun a project to develop a strategy for managing its domestic debt. Currently, the government is able to meet all of its financing needs with external sources of funds through grants or credits on highly concessional terms. It has a policy of zero net issuance of domestic securities for financing purposes, although existing government securities previously issued for financing are rolled over at maturity. Government securities are also issued for monetary policy operations, and, in effect, all domestic borrowings are now managed by the BoT.

At the time of this study, the government's strategy for managing external debt focused on debt relief and restructuring, as well as meeting the conditions for reaching the completion point of the Enhanced HIPC Initiative in 2001—clearly the highest priority, given the high value of the debt relief under this initiative and the importance of reducing debt to sustainable levels. Going forward, the strategy involves concentrating new financing in areas of national priorities, maximizing grant funding, and obtaining the remainder on highly concessional terms, preferably IDA-equivalent or better. This is also of high priority, given the importance of maintaining the burden of external debt servicing at sustainable levels.

External Debt Strategy

The external debt strategy is geared toward reducing the government's external debt burden to sustainable levels, limiting the buildup of new debt, and alleviating poverty. The strategy contains many elements of reform designed to

- Improve economic management and foster an environment conducive to private sector investment
- Strengthen the institutional framework and capacity to manage projects, build an accurate and comprehensive database for government debt, better coordinate sharing of information among key institutions in debt management, and improve the decisionmaking process for approving new credits
- Develop a program for training and developing professionals in all aspects of active debt management in the relevant government ministries and institutions

- Clarify responsibilities and criteria for appraising and approving new projects to ensure they are in line with government priorities
- Establish guidelines for the use of government guarantees
- Ensure that the conditions for loan disbursements are met
- Monitor and evaluate project implementation
- Ensure the availability of budgetary resources for servicing the debt
- Review and amend the legal framework to ensure accountability and make sure that new loans are not contracted without the approval of the Minister of Finance and that they remain within borrowing limits.

Most of these reforms have been implemented or are in the process of being implemented. The strategy also includes a plan for involving civil society in the campaign for debt reduction, establishing national priorities and decisionmaking on new debt, and launching debt awareness campaigns to inform the general public on debt-related issues.

There are a number of key components in the strategy for managing the existing debt portfolio and new borrowings:

- When contracting new loans, the government will ensure that debt remains within sustainable levels.
- New financing will be concentrated in priority areas of investment to support poverty alleviation and growth, primarily in agriculture extension, health, education, water and sanitation, transport, and energy sectors.
- The use of grant financing for approved projects will be maximized. Where grant financing is not available, the government's intention is to achieve concessional financing on IDA-equivalent terms (which contains a grant element of 78 percent) or better. The minimum level of concessionality that will be accepted is 35 percent, except on an emergency basis.
- Efforts will continue to qualify for debt relief under the HIPC program from multilateral creditors and implement the Paris Club V agreement for debt relief from member bilateral creditors.
- Donors will be requested to deposit US\$125 million annually into the established MDF, which is used for supplementing government resources for servicing credits from multilateral institutions.
- Negotiations will continue with non-Paris Club bilateral creditors to achieve debt relief on terms comparable to the Paris Club agreement.

- Existing arrears on commercial debt will be cleared through a debt buyback scheme, using the IDA Debt Reduction Facility.

Domestic Debt Strategy

The government has recently begun a project to develop a strategy for managing domestic debt. The project is being carried out jointly by MEFMI and a national team formed for this purpose. (The national team is advised by an external consultant.).

The key elements of the project to develop a domestic debt strategy, in order of their planned sequence, are:

- Data collection and validation
- Analysis of the domestic debt profile
- Analysis of domestic debt service and implications for debt sustainability
- Market survey and analysis of potential investors and ways to improve the market and trading profile for government debt securities, including the potential for marketable long-term debt and retail savings schemes
- Analysis of options for debt securitization and reissuance options, including the possibility of renegotiating the terms on nonmarketable securitized debt
- Construction of the institutional, legal, and regulatory framework for domestic debt issuance and management
- Econometric study of debt sustainability
- DSA according to HIPC criteria and interpretation of sustainability indicators
- Integrated analysis of external and domestic debt sustainability
- Design of domestic debt strategies and related reports
- Preparation of a report and presentation at a conference
- Finalization and distribution of the strategy document.

Policy Issues

External Debt

Although a strategy of focusing on reducing debt and maintaining it at sustainable levels should have the highest priority under current circumstances, the strategy lacks any reference to the risks of external debt. Despite the concessionality of new external credits allowed under this strategy, such credits are in foreign currency, and this exposes the government to unexpected increases in debt servicing measured in local currency terms and potential shocks to the budget. This poses risks to the fiscal sustainability of the external debt-servicing burden and can result in the need for substantial increases in tax revenues, cutbacks in government expenditures, and inflationary pressures. To manage these risks, an explicit treatment of both the cost and risk of external debt should be incorporated in the strategy.

Domestic Debt

As discussed above, at the completion point of the Enhanced HIPC Initiative, the present value of external debt is estimated at about US\$2 billion, and interest payments are estimated at about US\$60 million annually. This compares with an outstanding domestic debt stock as of March 31, 2001, of US\$930 million. Interest payments on domestic debt for the financial year through March 31, 2001, totaled TZS 61.5 billion (about US\$70 million). Extrapolating this figure through the end of the financial year, interest payments on domestic debt would total around US\$95 million in 2001. Going forward, this implies that domestic interest payments will have a larger fiscal impact than interest on external debt. Consequently, the project for developing a domestic debt strategy is very timely, and its completion should be a high priority.

The first key element of the project, data collection and validation, is already under way and is critical for the rest of the study to proceed. An effort is also under way to quantify and validate the unrecorded debt resulting from arrears on suppliers' credits, which is assumed to be part of this exercise. However, the extent to which this will include quantifying contingent liabilities—such as on-lent loans, the debt already issued as a result of privatization, and the outstanding debt and negative net worth of parastatals remaining to be privatized—is not clear from the description. These contingent liabilities pose potentially substantial risks to the budget and could result in large, unexpected future debt issuance by the government. In some countries, a lack of sound controls on contingent liabilities has led to large unexpected losses to the government, resulting in an unsustainable government debt burden and financial crisis.

In countries with underdeveloped domestic debt markets, the strategy for managing domestic debt should include a plan for developing the domestic debt market. The plan to do a market survey and consider options for dealing with the nonmarketable and unrecorded debt is a good first step. The analysis of the legal and regulatory framework for domestic debt issuance is also important, because this would help identify any existing impediments in these areas to the efficient operation of the domestic debt market. The development of the domestic debt market is discussed at length in chapter 5.

Another key element of the planned project, performing a DSA, should also be given high priority. The last DSA was conducted in 1999 as part of the HIPC exercise, and it focused on external debt. This should be updated using current data. Once the data on domestic debt have been validated, a combined fiscal sustainability analysis of domestic and external debt also can be conducted, as indicated in the timetable for the proposed project. Including data on contingent liabilities would also give a more accurate overall picture.

As with the external debt strategy, no mention is made of considering risk in the proposed design of a domestic debt strategy. Risks on domestic debt include interest rate risk and the risk that debt cannot be rolled over at maturity. These risks can be substantial when existing debt is concentrated in relatively short maturities, as is the current case in Tanzania for domestic marketable debt.¹³ An explicit consideration of both the cost and risk of domestic debt, as well as its sustainability, should be included in the analysis before a final strategy of domestic debt is concluded.

In a combined strategy for domestic and external debt, a balance will need to be struck between the cost and foreign currency risk of external debt versus the cost, interest rate risk, and rollover risk of domestic debt. Hence, any joint strategy for managing debt should be based on a cost-risk analysis of the debt as a whole.

The econometric analysis of fiscal sustainability planned in the proposed project may be of limited value, however, because such studies tend to focus largely on GDP growth compared with the interest cost of the debt, and the results can be distorted by the particular macroeconomic assumptions built into an econometric model. Moreover, fitting a reliable econometric model to a specific country can be a time-consuming and difficult exercise. As a supplement to the econometric model, insight into the fiscal sustainability of debt can be gained by a simpler exercise of incorporating total debt-servicing projections into the macroeconomic programming analysis, which is a part of a DSA for external debt, and directly examining the implications of this debt service for the government deficit and any adjustments that would need to be made to other macroeconomic policy objectives. Ultimately, fiscal sustainability is determined by the willingness of the government and the public to sustain high tax rates, inflation, or reduced spending on priority projects when the debt-servicing burden is too high.

Contingent Liabilities and Government-Guaranteed Debt

In the past, the government of Tanzania guaranteed most of the external debt issued by parastatals, and given the history of arrears on parastatal debt, much of this debt will have to be taken over by the government. Although guarantees are no longer used to the same extent, they are still authorized when the proceeds are used for investment in priority areas. Given their risks, they need to be tightly controlled.

¹³ With the excess liquidity currently in the banking system, rollover risk likely is not significant at present; but it could become more significant in the future as this excess liquidity is removed from the system.

In many countries, budget procedures require that the potential losses on guarantees be analyzed before they are issued, and the expected loss on any guarantee must be included in the budget. The beneficiary often is also charged a fee for the use of the guarantee based on this expected loss. The government of Tanzania would need to develop the capacity to perform this type of analysis and consider including expected losses under guarantees in the budget as well as pricing for their use. Given the current capacity limitations in the government, this would have to be a medium-term objective. In the meantime, the use of guarantees should be minimized, with tight controls placed on their use.

The external debt strategy document specifies that collateral must be pledged for any guarantees granted. Unless in cash, however, such collateral may be unavailable if a guarantee is called, because the value of a parastatal's assets is likely to be impaired if it is in financial difficulty. In addition to requiring collateral, guarantees should only be issued to parastatals that are in sound financial condition: if the information is unavailable to make this judgment, guarantees should not be issued.

The government is in the process of privatizing state-owned enterprises, which has required on occasion that the entity be recapitalized to make it attractive to investors. This has resulted in some new debt issuance, although the amount of such debt is unknown because it has not been compiled. Moreover, the potential debt that might be issued in the future as privatization continues is also unknown. As data on debt issued from past privatizations become available from the records in the Treasury Registrar, a high priority should be placed on compiling it. A project is also under way in the Presidential Parastatal Sector Reform Commission to compile a database of debt outstanding in parastatals remaining to be privatized; this should be completed as soon as possible. Analysis of the data on past privatizations could give insight into the potential for losses in the future.

Recommendations

An integrated sustainability and cost-risk analysis of external and domestic debt should be conducted:

- Updating the DSA for external debt and performing an integrated fiscal sustainability analysis of domestic and external debt are critical components of the planned project for establishing a domestic debt strategy, and they should be given a high priority. The planned econometric study of fiscal sustainability could be supplemented by a simpler analysis of the implications of debt service for the budget and other macroeconomic policy objectives through a macroeconomic programming exercise.
- The analysis of cost and risk of alternative debt strategies could begin with simple scenario analysis using existing tools. More sophisticated models for portfolio simulation can be added later, once the staff have developed the necessary capacity.
- The government should choose a strategy based on the costs and risks of the alternative debt strategies, taking into account its tolerance of risk and the vulnerability of fiscal sustainability to these risks. The approved strategy can then be translated into explicit guidelines or targets to guide new debt issuance.
- The project for developing a strategy for managing domestic debt should include an action plan for performing cost-risk analysis and incorporating this into the integrated strategy for managing domestic and external debt, as well as contingent liabilities.

The additional work needed to do this type of analysis is substantial, and considering the capacity constraints in the government, it is not recommended that the project be delayed until it is done. Rather, one of the outputs of the project should be an action plan for studying the costs and risks of debt and contingent liabilities and incorporating cost-risk considerations into the debt management strategy. In the meantime, no specific targets need be specified for the share of domestic versus external debt. A target based on DSA alone focuses only on costs, and because the risks inherent in both external and domestic debt are substantial, ignoring them would be the equivalent of basing a strategy on cost minimization alone.

Contingent liabilities need to be carefully monitored and controlled, and policies governing the use of guarantees should be strengthened:

Recommendations (cont'd)

- Contingent liabilities represent potential future claims against the government that can be triggered under certain circumstances. In Tanzania, they are substantial, and they need to be quantified and monitored. Potential losses from contingent liabilities should be estimated, and the potential issuance of new government debt resulting from such losses should be factored into the government's policy for managing debt.
- Policies for controlling these risks should also be developed.
- The future use of guarantees should be limited to beneficiaries that are financially sound. Over the medium term, the capacity to evaluate potential losses on guarantees should be developed, and policies governing the use of guarantees should take these into account.
- Data on debt issuance of past privatizations should be compiled, and the project for creating a database of the debt outstanding of parastatals remaining to be privatized should be given a high priority. These data can be analyzed to give insight into potential future needs to issue government debt to recapitalize parastatals for privatization.
- Procedures for ensuring repayment of on-lent loans need to be tightened. In the 1970s, the government often borrowed externally on behalf of parastatals and on-lent the proceeds for investment in priority projects. Arrears on these loans in the past appear to have been substantial, and the potential for future losses is unclear. Procedures for collecting on these credits should be tightened, and an effort should be made to evaluate the potential for future recoveries.

IV. CASH MANAGEMENT

As used in the context of a government's budget and debt management, the term *cash management* describes the process by which the government projects and manages day-to-day cash inflows and outflows. Initially this can be done monthly, with the process refined to project and manage cash flows weekly, and then ultimately daily. Best practice in developed markets requires that the government's cash flows be accurately forecast and managed daily.

Cash management requires accurate cash forecasting of revenues and expenditures by all government departments and the timely reporting of the forecasts to the agency responsible for their central management. This agency collates the individual forecasts, ensures that updates or other changes from previous forecasts are incorporated in a revised consolidated forecast, and produces an updated summary indicating the overall inflows or outflows of cash from the government account with the central bank. The debt manager then uses this information to establish the government's domestic borrowing requirement. The central bank also needs this information to manage the liquidity flows between it and the financial system.

To be effective, cash management requires a regular process of monitoring the expected payments and receipts, and the forecasts need to be continually updated to reflect the latest revenue and expenditure data. The effectiveness of the cash management process depends very much on obtaining accurate data and good information systems that provide reliable forecasts from each spending ministry or agency, as well as forecasts of tax receipts, donor receipts, and debt service obligations.

An accurate and timely system of forecasts cannot be achieved without the proper resources, staffing, and training. Cash management is a cooperative project that requires a positive attitude from all government and central bank officials involved. High-level leadership and commitment from the minister of finance and key senior executives are also necessary, so that the middle-level staff who do this work understand that this is an important task. The quality of their forecasting is an important factor in the government's objective of minimizing its financing requirements and interest costs. Thus, to prepare reliable forecasts, there is a need for sufficient resources of properly trained and motivated staff in both the cash management agency and in the other departments or ministries.

This chapter discusses the overall objectives of a cash management system, the cash budget process in Tanzania, the current revenue and expenditure forecasting and management arrangements, the problems of arrears of expenditure, improved debt-servicing

payment arrangements, the government bank account at the BoT, more flexible debt issuance arrangements, and cash management staffing and funding issues.

This part of the report also includes ideas for a more flexible, forward-looking management of government expenditure and financing beyond the current cash budget arrangements. It concludes with a number of recommendations on how to improve government cash management in Tanzania.

THE OBJECTIVES OF CASH MANAGEMENT AND RELATED POLICY ISSUES

There are three main objectives of a cash management system:

- To support the requirement for budget discipline within government, there is a greater emphasis on the need for every government ministry or agency to better forecast its expenditure. The process of cash management will help ensure that departments better understand their own business and the payment flows that are required to finance their activities or objectives. It will thereby help ensure that each ministry's actual expenditure is in accordance with the budget provisions.
- To ensure that idle cash balances of the government in the banking system are eliminated or minimized, thereby reducing any excess borrowing that would otherwise be undertaken: This ensures that the MoF is borrowing only the amount needed to finance its obligations to repay maturing debt, interest, and other expenditures that the government incurs. The government should be financing only the amount required for its actual expenditure to ensure that its interest costs are minimized. This allows the MoF to have a more efficient borrowing program that will minimize the government's borrowing costs.
- To enable the BoT to undertake the correct volume of liquidity management transactions to manage the liquidity in the financial system, which will contribute to a more efficient interbank market and allow for more stable short-term interest rates.

Predictability of the government's cash flows and their proper management are important factors in the functioning of a domestic financial market. The more unpredictable or volatile the government cash flows and the associated financing transactions are, the more uncertain investors will be of the government's ability to manage its financial affairs.

If the government's cash management and domestic borrowing are unpredictable, investors will obviously have less confidence. This reduced investor confidence will result in higher interest rates. The publication of reliable information on the government's cash flows and projected borrowing requirements allows investors to better manage their own portfolios as they anticipate and prepare for the government's borrowing transactions. They will then be better placed to bid in the government financing auctions, which helps to minimize government borrowing costs.

THE BUDGET PROCESS IN TANZANIA

Current Practice

In 1996, Tanzania adopted the policy of cash budgeting whereby the government was to spend only when it had first secured the means of financing, whether by way of tax revenue, donor funding, or concessional external funding. The objective was to control expenditure to ensure that the budget allocations were strictly adhered to, that the government met its expenditure obligations in a timely manner without accumulating arrears, and that its domestic debt obligations did not increase.

The MoF manages the government's expenditure within the context of the Medium-Term Expenditure Framework. The annual budget process begins in October or November, when all ministries and agencies submit their expenditure requests for the year. When the cabinet has approved the total annual expenditure, the ministries are required to submit a schedule of their monthly expenditure. The MoF's control over the expenditures is managed on a monthly basis, and approvals are given only for the next month when the revenue to finance the expenditure has been secured. Expenditure is identified and controlled on a line-by-line basis for each ministry.

A new IFMS was introduced in 1998, connecting all ministries to the AGD by an on-line, real-time computer network. This system is used to input and approve each item of expenditure before the expense can be paid. The system has built-in controls and limits, including the amount of available revenue, and facilitates a checking and reconciliation of each expense item with the budget allocation for that line item for the month. A request for payment will be approved by the AGD only if there is an available allocation for the current month. This system is now being expanded to cover the regional offices of the treasury.

Once the donor receipts (which finance most of the budget expenditures) have been received by the government, the individual ministries and agencies are given monthly expenditure allocations and are required to forecast these allocations weekly. The priority sectors, however, have recently been given quarterly expenditure allocations to allow them to better plan their activities. These allocations and the actual expenses incurred are recorded in the IFMS managed by the AGD.

The current cash budget system seems to have been very effective in bringing government expenditure under control by requiring that the revenue first be secured before expenditures can be undertaken, and it has eliminated the need for domestic borrowing.

Policy Issues and Arrears of Government Expenditure

More flexibility in the rules that currently limit ministries to spending on a month-by-month basis would improve their own efficiency in implementing their work plans. The recent decision to provide priority ministries with quarterly allocations of expenditure is therefore most welcome. Some thought should be given to expanding this concept to a longer period of commitment, perhaps annual commitments. It is important to emphasize, however, that this

would be done while continuing with a strong system of monthly monitoring and control over the actual expenditures and the monthly budget allocations for each ministry and line item, within the project completion requirements of individual donor programs.

This policy change would allow individual ministries to undertake more forward planning of their activities and thereby lead to more predictable management of their tasks and projects. It would, however, also require that each ministry or agency provide more reliable forecasts of their future expenditures.

It should be possible to achieve this new forecasting requirement within the facility of the IFMS. This more flexible and forward planning method of government activities is a comprehensive cash management system. It retains the necessary disciplines over government expenditure at the ministry and project levels, but by being able to give a greater certainty to the annual allocation for each ministry and project, it allows better planning and implementation of government activities.

Since the introduction of the cash budget procedures, the control over government expenditure by the MoF has gradually been strengthened year by year. However, the budget provisions have been very tight and have often not allowed sufficient funds for many activities, and there has been a practice of incurring expenditure that could not be paid from the budget allocations. This has led to the accumulation of arrears of government expenditure, estimated at the time of this study at up to TZS 85 billion. These arrears were mostly accumulated in the 1999–2000 fiscal year, before the introduction of a more strict expenditure control system for arrears in July 2000. Work was being done by the AGD to evaluate the extent of the arrears, and this amount would be subject to an audit evaluation.

A new Public Finance Act, which became effective July 1, 2001, is expected to have a considerable impact on reducing the rate of future arrears or unauthorized expenditure. The new act and associated regulations provide for sanctions and more binding penalties for the violation or misuse of public funds and should help bring the practice of incurring arrears under control.

The introduction of the new Public Finance Act and the associated regulations provided an ideal opportunity to undertake a more stringent control of new arrears and reinforce the importance of budget discipline across all ministries. Thus, special efforts should be made by the AGD to check for any new arrears since the introduction of the new act. A strong effort to reinforce the authority and discipline of the new act could help develop a better discipline within ministries and agencies, which will limit or eliminate the past practice of incurring arrears.

It is important that the AGD has sufficient, properly trained staff to undertake these verifications. It may be necessary to provide for additional staff to undertake this work. If these inspections are not made to enforce the new regulations, the government could be exposed to another gap in its budget control system.

Recommendations

- The audit of past arrears should be completed, the validated amount should be determined as soon as possible, and provision should be made for the amounts due to be paid. This process should be accompanied by an announcement that there will be no more acceptances of arrears of expenditure by the government.
- A more stringent inspection and discipline could be put in place with the introduction of the new Public Finance Act and the associated regulations, to reinforce the new rule that there are to be no more unauthorized expenditures without the necessary budget approvals and emphasize that sanctions will apply to those who break the new rules. The timing of the new act is ideal for reinforcing the message of fiscal discipline within government.

REVENUE AND EXPENDITURE MANAGEMENT

Current Practice

The government's annual expenditures are currently financed by tax revenue, donor grant support, and external borrowing without any net new domestic borrowing. The government has in recent years been rolling over the maturing domestic debt and financing some repayments from annual revenue sources. Most of the government's revenue comes from donor grants or concessional lenders, who together provide most of the annual budget expenditure financing.

The balance of revenue comes from taxation, which is collected by the TRA, a separate agency from the MoF. The tax collections are paid by the TRA to an account at the central bank for the credit of the government.

The TRA can pay the tax receipts to either a commercial bank or directly to the BoT for credit to the government account. When the TRA pays the tax to a commercial bank, the bank holds the funds for several days before it transfers the funds to the BoT. The commercial banks' holdings of this "tax float" amount to several billion shillings. This means that the credit in the government account at the central bank is lower than it would otherwise be, and the commercial banks have the use of a substantial amount of free funds that they can deploy in interest-earning investments.

Policy Issues

The delay in the transfer of the tax receipts is an undue enrichment of the banks at the expense of the taxpayer and the government. The rules governing the TRA collection of tax receipts and the transfer of these funds to the government should be tightened.

This could be done by introducing a penalty interest arrangement whereby the banks must pay interest to the government for the period they actually hold tax receipts, or new rules could be introduced to ensure that the tax receipts are promptly transferred by the commercial banks to the government's account at the central bank. Where there is a central bank facility for the collection of the tax receipts near the local TRA office, the rule should be that the tax must be paid directly to the BoT rather than a local commercial bank. The delay in the transfer of funds by the commercial banks to the TRA does not appear to be caused by a problem related to the payments system, but instead appears to be more in the nature of an opportunistic administrative arrangement by the banks, which provides some convenience for the local TRA office and a profit for the banks.

There is a further delay in the funds transfer of tax receipts by the Banking Department of the BoT when it makes the transfer of the funds from the TRA account to the exchequer account at the BoT. These funds are needed by the MoF to finance government expenditures, thus the tax receipt transfers should be made immediately so that the MoF obtains an immediate credit to its account. In addition, the authorities may wish to explore whether two separate accounts are really needed for the receipt and holding of tax receipts.

The extent of the accuracy in the forecasts of tax revenue from the taxpayer to the TRA is not clear. The objective should be to, in due course, move to a daily forecasting of the revenue receipts. This will require a tightening up of the holding arrangements with the commercial banks and an accurate timing of the initial payment by the taxpayers to the TRA.

Planning for a daily tax forecast system should be one of the objectives of the cash management project. Daily forecasts of tax receipts are intended to ensure that the government receives tax receipts as soon as they are due. In addition, for the central bank, these flows from the banking system to the BoT are part of the liquidity flows in the financial system that the central bank has to manage for monetary policy purposes.

Recommendations

- Changes could be made to the rules regarding the TRA's tax collection arrangements so that funds deposited with commercial banks are transferred to the TRA's account at the BoT for either same- or next-day value, and there should be rules in place to compensate the government for lost interest if transfers are delayed. Moreover, the BoT should transfer the credit to the MoF's exchequer account the day it receives the funds from either the TRA or a commercial bank.
- Work should be undertaken to forecast tax revenues and expenditures daily. This would ensure that the MoF receives its tax receipts as soon as they are due. Moreover, the BoT needs these forecasts to manage the daily amount of liquidity in the financial system.

DONOR-FINANCING ISSUES

Current Practice

The External Finance Department of the MoF manages the receipts from donors. Foreign currency receipts from donors are sold by the MoF to the BoT in exchange for Tanzanian shillings that can then be used to finance the respective domestic programs being funded.

Policy Issues

The rules for incurring expenditure require that the donor contributions must have been received and exchanged into Tanzanian shillings before expenditure can be charged to the corresponding project budget expenditure item. It is important that the MoF have accurate forecasts of when donor contributions will be received so that the budget credits will be recorded as soon as possible, and the corresponding project work can be begun or continued.

Some donors, particularly the multilateral lenders, are very good at providing advance notification of when they will be making payments, but other donors are not so forthcoming. The lack of reliable information from some of these bilateral donors presents major difficulties for the ministries undertaking the related project work because they cannot plan their projects in a reliable manner. It also complicates the conduct of monetary policy because the lack of certainty regarding the timing of foreign inflows hinders the management of the BoT's foreign reserves and the sterilization of these flows for monetary policy purposes.

Recommendation

Although the External Finance Department has tried to get better information from the more difficult donors, they have not been very successful in a number of cases. To the extent possible, additional efforts should be made by the MoF to strongly emphasize to the less cooperative donors that the quality of the government's project work in the area relevant to their grant is adversely affected as a result of the inability to properly plan the timing of the work involved.

DEBT-SERVICING PAYMENTS

Current Practice

The AGD maintains the government's records of debt and the debt service payments that the MoF has to make. In addition, the AGD must give the authority to make a debt service payment before the BoT will make the payment.

The BoT also maintains a database of the debt records, which it checks before making a debt service payment. There have been occasions in the past when the BoT has rejected a payment instruction from the AGD for debt servicing because it could not reconcile the payment with its own database. This delay accordingly resulted in a late payment on the debt.

Policy Issues

To avoid this difficulty and embarrassment, the AGD could provide a schedule at the end of each month to the BoT. For each debt service item that will be made in the coming month, the schedule would list all the individual debt payment amounts that will be due, the payment dates, and the counterparty payment instructions. The BoT should then immediately reconcile these upcoming payments for the month ahead to avoid the problem of last-minute differences in the debt payments.

It is important for Tanzania's reputation that all debt service payments are made on time, and these payments should not be delayed because of internal differences in databases.

There have also apparently been delays in the BoT making debt service payments because of a late delivery of the check from the AGD to the BoT. Internal measures between the two institutions should be adopted to ensure that this does not recur. An alternative arrangement for the payment of debt service payments could be examined. For instance, when the BoT knows that the AGD has authorized the upcoming debt payments, and they have been reconciled to its own database, it could make the payment from a previously authorized schedule of debt servicing by direct debit to the exchequer account without the need for an individual check for every debt payment.

Recommendations

- A system of advanced reconciliation of the debt records between the AGD and the BoT should be introduced to ensure that debt service payments are not delayed just because the two agencies have a difference in their own internal records.
- At the end of each month, the AGD should provide to the BoT and the lender a list of all the debt service payments that are due in the coming month, including the amounts of interest and principal, the payment dates, and payment instructions. The BoT could then reconcile all these upcoming payments before the due payment dates. Achieving this reconciliation and agreement well ahead of the payment date will eliminate the need to withhold a payment because the two databases are not reconciled. This system might also overcome the need to write a separate check for each debt service payment.

OVERALL GOVERNMENT BANK ACCOUNT

Current Practice

The government's receipts and revenue from all sources are consolidated into a single account at the BoT, although there is also a series of subaccounts to identify various sources of funding and different ministry expenditures. An overall bank statement, produced each day by the Banking Department, itemizes the opening balance, the tax and nontax receipts, the expenditure total for the day, and the closing balance. This is an important management tool for both the MoF and the BoT.

Policy Issues

In addition to the overall summary of the government's account, it is important that each ministry receive a daily statement from the BoT listing all the payments that have been processed through its own subaccount. Many small-value items, especially when they are paid in rural areas, will take some time before they are cleared in the banking system. Large-value items are easily recognized and are also likely to be cleared quickly.

Because a large number of payments are made to rural regions, there can be a delay of up to 30 days before some checks are cleared in the banking system. Thus, the total amount of government expenditure float held by the public is substantial. Although this float is large, it is also relatively stable in volume and, as such, does not cause a significant liquidity management problem for the BoT. The extension of the new electronic funds transfer system to the regions should reduce the amount of the expenditure float, because more large-value payments will be made in electronic form.

In 1998, work began on a national payments system project for Tanzania in line with the South African Development Community regional initiative. The project is scheduled for completion in 2005. The analysis and stocktaking phases were completed in 1998, and a document describing the planned national payment system was adopted in January 2000. Work on the conceptual design phase of the new system is in progress and was to be completed later in 2001. The effectiveness of this new system, however, is constrained by the limited communications and transport infrastructure in Tanzania. Upgrades to this infrastructure are needed if payment items are to be processed and moved rapidly across the country.

DEBT ISSUANCE DECISIONS, ALTERNATIVE MATURITIES, AND LIQUIDITY MANAGEMENT

Current Practice

The MoF holds large cash balances at the BoT, and there is not always one-to-one matching between the MoF's net cash flows and the amount of treasury bills issued for financing purposes. The BoT also varies the total amount of treasury bills to be issued each week for liquidity management purposes over and above the MoF's financing requirement for the week. The lack of precise matching between the MoF's weekly net expenditure and its

borrowing means that the difference between the two amounts is covered by fluctuations in the MoF's cash balances held at the BoT.

Policy Issues

The main maturities used for the MoF's financing requirements are 182- and 364-day treasury bills, although 91-day treasury bills can be issued for financing purposes when required. It would also be useful for the MoF to have a shorter-maturity bill, especially when it needs to cover a funding shortfall for a period shorter than 91 days. The MoF should have a greater range of maturities it can use, and it should also be the agency that decides how much to borrow for each maturity for financing purposes.¹⁴

The development of the new electronic payments system is likely to assist more accurate daily forecasting of large-value transactions. This and a more accurate daily tax forecasting arrangement would also assist the BoT's liquidity management functions.

Recommendations

- The MoF should be the agency responsible for deciding the volume of government bills and bonds issued in the weekly auctions for financing purposes.
- The MoF should be able to use a wider range of maturities for its borrowing requirements. This is especially the case when it needs to borrow for relatively short periods, such as shorter than 91 days. Flexible financing arrangements could be provided by the BoT to the MoF to ensure that the MoF can obtain funding when it is not practical to access markets directly. (There would be implications for monetary policy if flexible financing is provided by the BoT to the MoF to ensure funding when direct access to markets is not practical. The difficult market conditions could prevent the BoT from offsetting the MoF's net expenditure.)

¹⁴ There is merit in the BoT adopting a more flexible financing arrangement to support government financing needs. The policy that allows the central bank to provide an advance facility to the MoF, this being one-eighth of the average of the last three years' revenue, is a positive development. It is unclear how often this facility has actually been used to date, but it could be a useful feature of the government's financing arrangements for emergency situations when raising funds in the market is too difficult. This facility could operate like a revolving fund, so that when the delayed revenues are received, their receipts are then used to repay the advance from the BoT.

OPERATIONAL RISK AND STAFFING ISSUES

Current Situation

There are two areas of key operational risk in maintaining a properly functioning cash management system. The first risk is the uncertainty regarding the continued operation of the computer network that supports the IFMS. The second risk is the uncertainty about the availability of sufficiently trained staff to manage the forecasting processes and ensure that the correct information is being input into the cash management system.

The expenditure system is being managed through the IFMS. This is an important component of the government's ability to control its expenditures and ensure that program activities are implemented as efficiently as possible, given the need to ensure that the revenue must first be secured before expenditures can be approved. This system is now being expanded to cover the subtreasuries, which is a desirable and important development of the overall system.

Policy Issues

Although this system is technically very efficient and has been a factor in the government's ability to better manage its finances, it must be properly maintained in the coming years. This will require that provision be made for the necessary funding in the budget to ensure that the system remains fully operational and is not subject to breakdown. If the system is not functioning properly, it will not be possible to authorize expenditures when they are due, and work by individual ministries will have to stop because of a failure in the expenditure process. This is an important operational risk that the government now faces, and allowances should be made in the budget for this risk as priority for expenditures.

It is clear that the groups responsible for cash management, along with other sectors of the government, have difficulty retaining trained staff. The inability to retain trained staff means that the cash management system and the quality of the government's financial management will be less than optimal.

If staff continue to leave for opportunities outside the ministry, it will be necessary to continually invest in training for new recruits because there will be an ongoing requirement to continually employ and train new staff. Training budgets will therefore be more critical, especially because the cash management system is dependent on having a properly trained staff to do the work.

Recommendations

- Provision should be made in the government's budget for the necessary funding to ensure that the cash management system (the IFMS) remains fully operational and does not break down.
- Attention should be given to the difficult staff retention issues within the MoF, especially those concerning the cash forecasting requirements and the maintenance of the IFMS. This raises the question of the adequacy of salaries for affected personnel relative to the private sector, which may require additional financial compensation. Moreover, it is critical that provision be continuously made for an adequate training budget.

V. IMPROVING THE FUNCTIONING OF DOMESTIC DEBT MARKETS

A well-functioning domestic debt market expands the range of instruments available to the government to manage the costs and risks of its debt portfolio, and it alleviates the need for the government to rely on the central bank to finance its budget deficits. Moreover, by promoting the development of a deep and liquid market for its securities, the government can achieve lower debt service costs over the medium to long term as liquidity premia embedded in the yields on government debt wane. A stable macroeconomic environment is a prerequisite for developing the domestic debt markets, and sound management of the risks of the government's own debt portfolio can contribute to financial stability. By promoting the development of an efficient domestic market for government securities, and by establishing a yield curve for government securities that can serve as a pricing benchmark for other issuers, a government's debt issuance practices can also serve as a catalyst for the development of deep and liquid money and bond markets more generally. This helps to reduce the vulnerability of the economy to external shocks by providing borrowers access to alternative sources of financing, and it expands the menu of instruments available to the government to manage the costs and risks of its own portfolio. This chapter examines the current functioning of the domestic market for Tanzanian government securities and offers some suggestions to further the development of this market.

The financial system in Tanzania currently consists of 17 banks, and 13 small nonbank financial institutions, a postal savings bank, and 4 government-sponsored pension and social security funds. The 6 largest banks control 93 percent of banking system assets, the largest of which—the NBC—dominates the system with an asset share of 36 percent. Also, the Dar es Salaam Stock Exchange (DSE) started its operations in April 1998. Five securities are listed, and trading activity is limited to a handful of transactions during the half-hour trading session that takes place three days per week.

The financial system is very small compared with neighboring countries in the region (table 5.1). In part, this may reflect (a) the low level of per capita income in Tanzania (countries in the region with higher per capita incomes tend to have more developed financial systems) and (b) the weak state of Tanzania's banking system during the 1990s. Thus, much of the economy, notably in the rural agricultural sector, operates on a cash basis outside the financial system. This may serve as a constraint on the potential growth of financial markets in Tanzania until this economic activity is brought into the financial system.

Table 5.1 Tanzania: Comparison with Other Countries in the Region

<i>Country</i>	<i>M2/GDP</i>	<i>Private sector credit/GDP^a</i>	<i>Currency/GDP</i>	<i>Real GDP per capita^b</i>	<i>Openness of the economy^c</i>
Botswana	21.8	16.6	1.6	3,930.0	105.1
Kenya	42.7	27.7	5.5	333.0	63.2
Mozambique	23.2	18.9	4.1	262.0	54.5
Rwanda	16.2	9.3	3.5	320.0	31.1
South Africa ^d	57.3	73.4	2.6	3,005.0	53.7
Tanzania	14.7	4.7	5.4	192.0	40.1
Uganda ^e	14.4	6.4	4.1	380.0	41.9
Zambia ^f	15.9	10.6	2.5	360.0	75.0
Zimbabwe	36.3	22.6	3.1	737.0	57.2

a. Includes credit to nonfinancial public enterprises.

b. In U.S. dollars, at 1990 prices, using 1990 exchange rates.

c. Exports and imports of goods and services (in percent of GDP).

d. November 2000 numbers for private sector credit and currency outside banks.

e. December 1999 numbers for private sector credit and currency outside banks.

f. October 2000 numbers for private sector credit and currency outside banks.

Source: *World Economic Outlook* database, IMF, summer 2000.

Government securities are mostly purchased by banks and pension funds at auction and held until maturity. Despite the introduction of a primary dealer system, a book-entry system, and ongoing reforms to the payment system, there is almost no secondary market trading. The banks and pension funds have a strong desire to hold these securities on their balance sheets until maturity because the yields on government securities have been considered to be attractive relative to lending to enterprises and households. Existing regulations inhibit banks from lending against collateral in the form of land or real estate, and the traditional legal system is perceived to be very slow in processing claims against defaulting borrowers and biased against banks.¹⁵ Indeed, demand for these securities continues unabated, even though their yields are now below the rate of inflation as a result of the lack of alternative investment opportunities.

¹⁵ In response, the authorities established a commercial court in Dar Es Salaam in 1999 to expedite foreclosures (additional courts were to be opened). They are also changing regulations to allow land and real estate to be used as collateral and working with the banks to establish a private credit information bureau to make it easier to obtain credit risk information about prospective borrowers. Banks recognize the commercial court's ability to quickly process claims against delinquent borrowers, despite the high costs of this legal channel. However, they suggested the overall impact of this court on the lending environment may be constrained by the fact that borrowers can still appeal commercial court rulings to the traditional legal system. Moreover, some banks are finding it difficult to liquidate seized collateral at "reasonable" prices because of the shallow market for such assets in Tanzania and, in some cases, because collateral may have been overvalued when the loan was granted.

This implies that one should not expect investors to begin to actively trade government securities in the secondary market any time soon. Rather, the recommendations put forth in this chapter mainly aim to ensure that a proper market infrastructure is put in place ahead of time, so that when investors are ready to begin trading, they will be able to do so in an efficient, cost-effective manner. The first two sections in this chapter examine steps that can be taken to improve the functioning of the primary and secondary markets for government securities. In the third and fourth sections, the supporting infrastructure is reviewed, specifically the functioning of the money market and the Central Depository System (CDS).

DEVELOPING THE PRIMARY MARKET FOR GOVERNMENT SECURITIES

Current Practice

As noted previously, domestic government securities are issued only for liquidity management purposes, because the government's borrowing requirements have been largely met through external concessional financing. The BoT auctions four different securities on Wednesday of each week in the name of the United Republic of Tanzania. These are treasury bills for 91, 182, and 364 days, and a 2-year, semiannual, coupon-bearing bond.¹⁶ All securities are issued under a prospectus.¹⁷ For internal accounting purposes, the treasury bills offered at the weekly auction are separated into financing paper and liquidity paper. The BoT covers the interest cost of the liquidity paper, which is issued for monetary management reasons. In general, the 91-day bill is used for liquidity purposes, and the other maturities are issued as financing paper. In principle, any maturity can be used for liquidity purposes, and, recently, a significant amount of liquidity paper has been issued for longer maturities, as seen in table 5.2.

¹⁶ The bond is issued each week at par.

¹⁷ Government securities are issued under the Government Loans, Guarantees and Grants Act Number 30 of 1974. Prospectuses for treasury bills and bonds outline in detail the issuance terms and conditions of each type of security. The treasury bill prospectus contains the unfortunate statement that an investor *cannot* lose on the investment, ignoring the fact that there is always a risk that governments may default on their obligations, and losses can arise through adverse interest rate movements if the security is sold before maturity.

Table 5.2 Outstanding Stock of Liquidity Paper by Maturity (TZS million)

	<i>91 days</i>		<i>182 days</i>		<i>364 days</i>	
	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>
September 20, 2000	33,888	74.8	4,611	10.2	6,793	15.0
March 13, 2001	41,519	49.7	24,140	28.9	17,884	21.4

Source: Bank of Tanzania.

The BoT decides on issuance of liquidity paper, and the Accountant General or the Permanent Secretary of the MoF must authorize any increase in the amount of financing papers. The BoT takes a strong lead in a number of areas related to the issue of securities (such as size of new issues), which in large part is a result of a lack of a domestic debt management strategy on the part of the MoF.

The auction is the BoT's main instrument of monetary management. In late 2000 and early 2001, the BoT issued a substantially greater amount of securities than initially announced, thus withdrawing additional liquidity and raising the average auction rate. Commercial banks were generally of the opinion that the BoT was attempting to nudge interest rates higher.

The auction format for treasury bills is multiple price with settlement T + 2 (Fridays). The format for the two-year bond is uniform price with settlement T + 1 (Thursdays).¹⁸ The auction process, as far as participants are concerned, begins with an invitation to tender placed in weekend newspapers. These announcements describe securities and amounts offered and the timing for bidding (Wednesday at 11:00 A.M.) and results (Wednesday at 1:00 P.M.). The announcement of results provides comprehensive information on number and value of bids, number and value of successful bids, highest and lowest prices bid, and lowest and weighted average successful yields. Auction access is open to any bidder, subject to a minimum bid size of TZS 100 million. Small bids are channeled through primary dealers, with a minimum bid size of TZS 500,000.^{19,20}

¹⁸ The bond is tax exempt, but the treasury bills are subject to a 15 percent withholding tax.

¹⁹ The primary dealer system was introduced in December 1998 and consists of 12 commercial banks plus 5 broker-dealers. All primary dealers are expected to abide by a code of conduct drawn up jointly by the BoT and the Capital Markets and Securities Authority (CMSA) in consultation with the primary dealers. The code covers dealing conduct generally and primary dealer obligations. The CMSA is the supervisor for the broker-dealers, and the BoT supervises the commercial banks.

²⁰ These conditions are widely understood, but are not correctly represented in the invitation to tender, which simply states that the minimum bid is TZS 500,000.

The code of conduct for primary dealers imposes two obligations.²¹ First, primary dealers must demonstrate an active commitment to participate in Government securities auctions, and on-selling the purchased securities to investors in the secondary market. Second, primary dealers should be willing at all times to buy or sell the security at their quoted price in a marketable amount. It is clear that these conditions are not observed, and some primary dealers are unaware of their obligations. In view of current conditions of excess liquidity and the lack of economic incentives for primary dealers to trade, the BoT has not enforced the market-making obligations. In these conditions, there are almost no intrinsic benefits from the current primary dealer system.

Settlement procedures involve the BoT automatically debiting primary dealers' accounts;²² other successful bidders settle by bank checks.²³ These checks have to be delivered to the BoT by 3:00 P.M. on the Friday after the Wednesday auction but are not sent to the clearinghouse until Monday.²⁴ Government securities are registered in book-entry form in the Central Securities Depository administered within the BoT. Securities are allocated to investors' accounts and are available for trading on the Monday after the auction.²⁵

Policy Issues

An integrated cost-risk analysis of the appropriate mix of domestic and external debt for Tanzania would require a specification of the maturity and interest rate composition of new domestic debt as it is issued, and the feasible choices will depend on the pace of development of the domestic debt market. The faster the market is developed, the better the tradeoffs between cost and risk are likely to be because this expands the choices of possible debt instruments. However, an overly rapid expansion of government borrowing in the domestic market may crowd out the private sector, and this also needs to be considered. Crowding-out effects can be substantial when the capital account has not been fully liberalized, as is the case in Tanzania.

²¹ Primary dealers are not granted any privileges.

²² Commercial banks have settlement accounts, and broker-dealers have accounts at the BoT solely for the purpose of settling government securities.

²³ The settlement risk with nonbank participants is the same as that with bank participants because nonbanks use bank checks (that is, checks that are drawn on banks and not individuals).

²⁴ The Banking Department passes an entry on the Friday crediting the treasury bill account and debiting a suspense account. The latter account is cleared out only after the Monday clearing. This effectively results in BoT funding the government over the weekend, with commercial banks enjoying free use of funds over the same period.

²⁵ The operation of the book-entry system is covered in detail in another section of this chapter.

The process surrounding the issuance of new government securities functions fairly well in Tanzania, but there are several areas where changes could be made at the margin to make the primary market more efficient and bring it more in line with international practice.

First, the debt stock is highly fragmented. At any one time, there are 52 treasury bill and 104 tradable bond maturities outstanding—too many, given the limited amount of total tradable debt outstanding. Such a high degree of debt stock fragmentation can make it difficult for investors to trade efficiently, because they need to hold a number of different securities in their portfolios for a given desired overall exposure to Tanzanian government securities.

In more developed financial systems, it is unusual to issue bonds on a weekly basis, particularly with a new coupon and maturity auctioned every week. The amount outstanding of each bond is an important—but not the only—determinant of secondary market liquidity. Issuers often target the same maturity date through more than one auction, with the objective of building up larger tranches of bonds, and reduce the number of securities outstanding (fragmentation) that make up the debt stock.

One approach to reducing the debt stock fragmentation is to reduce the auction frequency for bonds to once every four weeks and issue the same bond (that is, same coupon and maturity) in three successive auctions. This entails setting the coupon rate on the bond at the first auction, with subsequent issuance of that bond likely to be at a discount or a premium to face value. It should also be noted that the BoT would face additional liquidity management challenges when these larger tranches mature, but there are strategies for dealing with this issue.²⁶ Similar changes could also be made to the issuance of treasury bills if the authorities wish to reduce the number of treasury bill issues outstanding.

Second, although it is not a serious concern in Tanzania, the two-day lag between the auction and settlement of treasury bills exposes the government to settlement risk if an investor fails to honor its auction commitments.

Third, the amount of uncertainty in the market surrounding the auction process is heightened by the past practice of occasionally issuing more securities at the auction than had been originally announced in the call for tender. Such a practice may affect bidding behavior in subsequent auctions because investors will adjust their bidding for the risk that the amount auctioned may not be the same as the amount announced. In turn, this could result in higher borrowing costs for the government as this uncertainty is passed on to the government through changes in bidding behavior.

There is currently no constraint on the amount of securities that the BoT can issue at auction. Limiting the amount issued to that announced in the call for tender could help ensure that bidding behavior in subsequent auctions is not distorted by uncertainty in the market surrounding the amount of securities that will actually be issued. Deviations from such a

²⁶ For example, the BoT could enter the market and repurchase bonds before maturity or could offer to swap the bonds for a longer maturity, thus shifting forward the liquidity effect.

practice are normally entertained only in situations where the authorities have clear evidence of attempts by an investor (or group of investors) to corner the market. In such cases, adjusting the amount issued may help to maintain investor confidence in the integrity of the auction process.

Constraining the amount issued to the amount announced in the call for tender would also imply that the BoT would no longer be able to adjust the amount of liquidity paper issued at auction to respond to liquidity shocks that may arise between the release of the call for tender (weekend) and the auction (Wednesday) until the next auction. However, there are other instruments available to the BoT to respond to such shocks. For example, it could execute repos with market participants during the week after the call for tender that could be set to mature the following week, when the next auction settles. Alternatively, if the BoT did not have enough marketable securities on its balance sheet to conduct repos, it could achieve the same result through the foreign exchange market by executing short-term foreign exchange swaps with commercial banks. If the BoT pursued this latter option, it would need to introduce some safeguards to protect itself against the risks inherent in foreign exchange swaps and would have to ensure that appropriate disclosure practices are in place to ensure that market participants and the general public are aware of the resulting future claims against its holdings of foreign assets.²⁷

Fourth, the lack of tradable, longer-term government securities may inhibit broader domestic debt market development because investors are not able to look to the yields on government securities to price longer-term private debt as a result of the short maturity of the existing yield curve. One way the government can increase the amount of tradable securities outstanding, if it believes it does not need to issue more domestic debt to fund its fiscal activities, is to convert the nontradable debt stock into tradable securities.²⁸ For example, as the nontradable debt matures, it could be repaid by issuing additional treasury bills or more marketable bonds. Retiring the nontradable debt ahead of maturity would not appear to be practical at this time because much of this debt is long term in nature and determining a fair repurchase price is almost impossible in the current environment, where there are no tradable longer-term securities outstanding. Instead, it might make more sense to lift the restrictions on the trading of these securities so that the holders could sell them into the market whenever they wished.²⁹ Similarly, the authorities could consider financing domestic arrears with new issues of marketable debt.

²⁷ The merits of central banks using foreign exchange swaps and the appropriate safeguards that central banks can use to protect themselves against the counterparty and settlement risks inherent in these swaps are discussed in Hooymann (1997) and Zelmer (2001).

²⁸ As of March 31, 2001, the nontradable securitized debt represented more than half of the volume of the domestic debt outstanding and was expected to increase as additional debts are issued to recapitalize parastatals with negative net worth.

²⁹ An important step would be to ensure that interest and principal obligations associated with these securities are always paid promptly, so that the securities are considered by investors to be of the same quality as treasury bills and two-year marketable bonds.

When considering options for dealing with the nonmarketable debt, there is a temptation to renegotiate this high-cost debt at lower interest rates to reflect the new market environment. This should be avoided. Because most of this debt is held by the BoT and commercial banks, such negotiations might meet with some success—particularly with the commercial banks, who at present have few investment alternatives, given the excess liquidity currently in the banking system. Forcing lower interest rates for this debt on the commercial banks would, however, result in lower profits and could induce them to try to recoup these losses through wider intermediation spreads, thereby creating additional distortions in the system. The commercial banks might also attempt to recapture profits through imprudent lending to risky borrowers at high interest rates, which could result in insolvency. Artificially setting prices on nonmarketable debt would also be counter to the objective of establishing an efficient market for government securities. In well-functioning markets, securities with fixed rates higher than the current market rates would be expected to trade at a premium to their par value based on the present value of the future payments using current market rates as the discount factor. Options for encouraging the marketability of this debt should be explored instead, which would allow these securities to trade at their true market value.

Recommendations

- Elaborate a strategy for developing the domestic debt market. When choosing among various strategies, one should consider the potential benefits of reducing costs and risks to the government through an aggressive expansion of government borrowing in domestic markets versus the potential for crowding out the private sector. This strategy also should consider options for extending the yield curve for government securities through a gradual expansion of the maturities of new government debt issuance to tradable long-term government securities.³⁰
- Review the government's debt management policy, and consider options for the gradual conversion of the existing stock of nontradable government securities and domestic arrears to marketable debt issues. There is a temptation to want to renegotiate this high-cost debt at current lower interest rates. However, forcing lower interest rates on the banks in question could induce them to try to recoup their losses through wider intermediation spreads or imprudent lending, thereby creating additional distortions in the system. It would also run counter to the objective of establishing well-functioning debt markets. Artificially setting prices on nonmarketable debt would also be counter to the objective of establishing an efficient market for government securities in well-functioning markets.
- The frequency of bond auctions could be reduced to perhaps one every four weeks. The same bond could be offered at three successive auctions, so that in effect four maturities are issued each year.³¹ Decisions on frequency and size of auctions should be made public in the form of an auction schedule.
- Consider shortening the settlement period for treasury bills, initially to T + 1 and eventually to same-day settlement.

³⁰ On February 27, 2002, the BoT announced the launch of a new five-year treasury bond, with the purpose of lengthening the maturity profile of government debt and extending the yield curve.

³¹ Since the draft report was presented to the Tanzanian authorities, the BoT has announced the decision to discontinue the weekly auctions of treasury bonds. The announcement indicated that treasury bonds will be auctioned monthly, using the internationally accepted tranching or reopening system. Under this system, a treasury bond issued in the first month of a quarter (parent bond) will be reopened (with the same coupon rate and maturity date) in the next two months of that quarter, so as to increase the outstanding volume of the parent bond.

Recommendations (cont'd)

In the medium term, BoT activity in the context of pursuing monetary policy objectives on a weekly basis will set the stage for more frequent interventions, perhaps ultimately on a daily basis. This would require shortening the settlement period for treasury bills, ideally to same-day settlement. Moving treasury bills to same-day settlement would also help to reduce systemic risk in the financial system by reducing the risk that investors might not honor their obligations at time of settlement.

- The amount of securities issued at auction should normally be the same as the amount announced in the call for tender. To minimize uncertainty in the market surrounding the government's debt management activities and enable investors to manage their portfolios efficiently, debt issuance decisions of this nature should be announced publicly and in advance in the form of an auction schedule, specifying the securities to be issued and indicating the range of prospective issue sizes. The exact amount of securities to be issued would be announced at the time of the call for tender. Rather than issue a different amount of treasury bills than originally announced, the BoT could make use of other instruments, such as repos or foreign exchange swaps, to offset any liquidity shocks that may arise after the call for tender.

DEVELOPING THE SECONDARY MARKET FOR GOVERNMENT SECURITIES

Secondary markets allow end-investors to adjust their holdings of government and other market securities as new information becomes available—or as investor portfolio needs or market perceptions change. Although many countries have been successful in introducing a primary market for government securities, developing an active secondary market has proved to be more difficult because the willingness to transact depends on market participants. However, the central bank's open market operations and the government's debt management policies could play an important role in the design of the microstructure of the secondary market through their influence on transactions types and trading procedures in the market, as well as through promoting efficient trading systems and market transparency. Notwithstanding this, secondary market trading can only develop once the general economic and market conditions provide incentives to trade.

Current Conditions

Secondary market trading in treasury bills and bonds is essentially nonexistent. The market's development has naturally been inhibited by the high level of excess liquidity in the banking sector in view of the absence of alternative investment opportunities; the growth in bank lending is slow because of high credit risk and weaknesses in the legal framework for enforcing creditor claims. At the same time, the DSE has only recently been established, and only five stocks are listed. As a result, banks and institutional investors tend to buy government securities as their main investment and keep them until maturity. Accordingly, existing financial market conditions do not provide sufficient incentives for banks to trade these securities.

The code of conduct for primary dealers, which was introduced in December 1998, specifies their market-making obligations only in vague terms. It states that primary dealers should be willing at all times to buy and sell the securities at their quoted price and in marketable amounts. It does not, however, specify that primary dealers are obliged to quote two-way prices at all times. In this context, the BoT has not enforced market-making obligations on primary dealers, particularly in view of current conditions of excess liquidity and the lack of economic incentives for primary dealers to trade.

Policy Issues

It is expected that secondary market trading will develop when conditions become conducive, but the authorities can still play an important role in the development of secondary market transactions. Specifically, they could enhance the liquidity of government securities and affect the design of the microstructure of the secondary market by working with market participants to define trading procedures in the market, and they could promote efficient trading systems and market transparency.

Because marketable securities are currently concentrated in treasury bills, it is expected that secondary market trading in Tanzania would begin at the short end of the yield spectrum. Furthermore, banks tend to carry the bulk of marketable securities, and banks would be the natural market makers for the secondary market in Tanzania. If and when liquidity conditions tighten and bank treasurers become more active in managing their portfolios, the authorities can play an active role in the development of the trading microstructure and enhancing price transparency. At first, the authorities could encourage the introduction of weekly secondary market auctions, but the frequency would need to be increased along with demand. Floor-based open outcry could be used (see appendix 2). The role of the auctioneer could be performed by a neutral private sector entity, such as the Tanzanian Bankers Association, or if the private sector cannot agree on a suitable auctioneer, by the BoT. Over-the-counter (OTC) trading could be allowed between auctions.

The secondary market in Tanzania still is in its initial stages, thus it is necessary that the number of trading sessions be limited, at least during the first phase of market development, so that buy and sell orders can be concentrated. Lowering the market auction frequency would consolidate orders arriving at the market, thereby increasing the number of

traders and deepening the volume of orders per trading session. This would also reduce price volatility. If investors wished to trade at other times than during the short price-fixing session, they could be allowed to do so by permitting them to trade among themselves on an OTC basis.³² As turnover in the weekly auction increases and the market risk associated with periodic markets of low auction frequency rises, a transition to higher frequencies, and possibly to a continuous market with market makers capable of providing continuously firm two-way quotes, would be necessary.³³

In the medium term, once the demand for secondary market trading increases, the secondary market could be organized as open-outcry call auctions. In addition to providing a simple market form for trading, an open-outcry auction has several advantages that result from both its general function as a periodic market and features specific to the organization of the open outcry. In addition to benefiting from an intertemporal consolidation of market orders, this market form entails low transaction costs as a result of the absence of intermediation fees (brokerage fees or bid-ask spread) and lower costs associated with the order handling of a centralized market structure. Moreover, with a single price outcome, transparency in price formation and equal treatment of all market participants are ensured. Price discovery is interactive, thus market players are able to react to the submission of orders and the formation of prices by submitting new orders, which provides an efficient market for price discovery. At this stage of market development, real-time information would be available to traders on the floor (and possibly to others over the telephone).

The auctions would be conducted at the auctioneer's premises, with its staff acting as the active auctioneer. In this regard, the BoT and the auctioneer could form an auction committee of potential market participants to arrive at agreeable trading rules (such as opening price and order submissions) among market participants. The auction would be open to all interested participants.

As the market develops, these auctions could also include trading in government treasury bonds. However, virtually any medium- or long-term government bond could be a clear candidate for stock exchange listing. In theory, provided transaction costs are reasonable, a stock exchange may be well placed to carry out market surveillance, particularly in ensuring that the rules of the market are observed and unfair practices prevented. Stock exchange listing also ensures a high degree of transparency, thus adding to credibility in the early stages of market development. Trading government securities on the stock exchange provides market participants with further opportunity for stock market trading and could contribute to the development of the DSE by providing long-term benchmark interest rates that would provide the basis for pricing corporate bonds. Provided

³² At first, because the interval between trading sessions would be relatively long, price fluctuations between trading sessions would be expected.

³³ The development of foreign exchange and treasury bill markets in many economies in transition was done in a similar way. In Kazakhstan, for example, the central bank in 1994 initiated the secondary market for treasury bills by organizing several call auctions. As the market developed and traded volumes increased, more frequent trading began to occur in the OTC market. The transition from periodic markets to continuous markets has been completed by some countries of the former Soviet Union.

that the DSE has established adequate market credibility in terms of disclosure practices and transparency of operations, consideration could be given to listing government bonds on the stock exchange. Nonetheless, even if the bonds are listed on the exchange, market participants should retain the right to transact on an OTC basis, subject to BoT supervision, so that the market as a whole can determine which market mechanism provides the most efficient trading forum.

Although the large foreign banks and institutional investors could quickly obtain computer software that would help them price their treasury bill and bond holdings, it may not be economical for other participants to acquire these tools until trading activity has developed sufficiently to justify their purchase. Some banks have suggested that in the meantime, the BoT should consider placing a simple bond-pricing program and a crude yield curve model on its website, to be accessible to all investors. Such tools would help to educate smaller institutions on how to price government securities, thereby making it easier for them to participate in the secondary market as it begins to develop.

Recommendations

- In the medium term, once the demand for secondary market trading increases, the secondary market could be organized as an open-outcry call auction.

The authorities can play an active role in the development of the trading microstructure and enhancement of price transparency. Initially, the authorities could encourage the introduction of weekly secondary market auctions, but the frequency would need to be increased along with demand. Floor-based, open-outcry, call auctions could be used (see appendix 2).

As turnover in the weekly auction increases and the market risk associated with periodic markets of low auction frequency rises, a transition to higher frequencies, and possibly to a continuous market with market makers capable of providing continuously firm two-way quotes, would be necessary. As the market develops, these auctions could also include trading in government treasury bonds.

- To make it easier for investors to value their holdings of government securities, make bond pricing algorithms and yield curves readily available on the BoT's website.

MONEY MARKET

Current Conditions

The development of a money market in Tanzania has been slow, particularly in view of the substantial excess liquidity in the financial system. For example, issues of commercial paper

have been very sporadic as a result of the liquid state of the banking system and the limited number of borrowers that would be sufficiently financially strong to access this market directly. The interbank market continues to be based on unsecured lending. Transactions are initiated over the telephone, and maturities range between one and seven days;³⁴ the bulk of transactions, however, is concentrated in the overnight tenor.³⁵ The market remains thin; data on interbank transactions for the period between September 2000 and March 2001 indicate an average of 70 monthly transactions, with an average monthly transaction volume of TZS 76 billion.

In general, banks report adequate access to the interbank market, although there is some segmentation between larger and smaller banks. Trading volumes grew rapidly after the market was established in July 1997, from TZS 9.6 billion in April 1998 to TZS 71 billion in November 1998. This reflected changes in the mandatory reserve requirements introduced in June 1998, which oblige banks to maintain reserve requirements for domestic and foreign currency deposits in Tanzanian shillings. The interbank market is therefore largely driven by three major foreign banks that borrow in the interbank market to meet their reserve requirements on foreign currency deposits. These three banks account for about 95 percent of the interbank borrowing volume. On the lending side, the market is dominated by the three largest domestic banks, whose lending accounts for about 55 percent of the total. Other selected, smaller banks appear to be on both sides of the market.

Intraday variations in interest rates are very small (about 25 basis points). Notwithstanding the lack of a sophisticated information-sharing system in the market, excess liquidity and the limited number of transactions allow banks to “shop around” for better deals. There is no clear indication of price differentiation on the basis of risk.³⁶ However, major banks are not willing to deal with counterparties that are perceived to be in weak conditions.

The BoT has made progress in introducing a book-entry system (see the next section, “Central Depository System for Government Securities”), which is now fully operational, but it needs to be adequately advertised to all banks.³⁷ With some modifications—such as allowing securities to be transferred from one party to another in any amount and in parcel sizes different from the size in which they were first issued to increase their fungibility—this system should be able to efficiently support interbank repo transactions with government securities. However, progress on introducing a master repurchase agreement for repo

³⁴ Currently, only four banks in Tanzania have Reuters screens.

³⁵ There is a very limited number of transactions with longer maturities (up to 182 days). These are conducted on secured basis, using treasury bills as pledged collateral.

³⁶ The BoT currently distributes a weekly publication to banks that summarizes the previous week’s interbank transaction volumes and prices. Interbank payment orders are still paper based, and fax copies are not accepted by the BoT.

³⁷ Many market participants are not aware that the BoT has introduced the book-entry system and accordingly continue to request physical securities when purchasing securities at the primary auctions.

operations has been lacking. The BoT has introduced an agreement for repo transactions between itself and the commercial banks and has initiated an effort to develop such an agreement for use between banks. However, there has been little enthusiasm among commercial banks for carrying this process forward because of the low volume of interbank transactions. As a result, no progress was made in this area in the two years preceding this study.

Policy Issues

Money market activities can develop only when banks have incentives to manage their liquidity more efficiently. The limited number of sound lending opportunities has resulted in a high level of excess liquidity of commercial banks relative to the supply of tradable securities (treasury bills). This situation has hampered the development of active trading in the interbank and broader money markets, and thus it has held back the development of such instruments as repo operations among banks. However, interbank activities would be encouraged by an infrastructure adequate to support the growth of the market when other conditions in the banking system also become conducive to this growth. This includes the establishment of a legal basis for repo transactions through the introduction of a master repo agreement, enhancing price discovery by improving information availability on interbank transactions, and efficient use of the book-entry system to support secondary market transactions.

Another important element in promoting the development of a deep and liquid money market is the design and operating modalities of the BoT's procedures for implementing monetary policy. Although these are generally functioning well, there are some technical adjustments that could be made to promote a well-functioning interbank market.

Replacing the overdraft facility by a short-term Lombard facility would also strengthen the money market. The Lombard facility should be designed in such a way that it can also serve as an overdraft facility. This would require (a) minimum maturity for Lombard credit of one business day, (b) ability for banks to obtain Lombard credit at the end of the day without a prior request to the central bank, and (c) collateral to be deposited in advance at the central bank or readily accessible (for instance, through the book-entry system managed by the central bank), so that the central bank can appropriate the collateral when needed without a prior approval of the bank. (This will, however, require the bank to authorize the central bank to appropriate the collateral when needed.)

Lombard loans are intended for special circumstances, such as unexpected fund shortfalls, and are not meant to provide a permanent source of central bank funding to individual banks or to the system as a whole. Accordingly, as a matter of policy, central banks may also discourage access to Lombard loans through ceilings on individual institutions or by simply closing access to the facility in exceptional circumstances.

Recommendations

- Encourage banks to speed up the process of formalizing a master repo agreement for interbank operations.
- Increase the frequency of the distribution of information by the BoT on interbank transactions from a weekly to a daily basis.
- When liquidity conditions permit, exclude interbank deposits from the deposit base for the purposes of calculating banks' reserve requirement at the BoT. The double-counting involved in the inclusion of interbank deposits in the deposit base used to calculate reserve requirements adds to transaction costs of interbank activity and is detrimental to the development of that market. Furthermore, including these deposits provides no additional benefits in terms of monetary control.
- Replace the Unsecured Overdraft Facility at the BoT with a short-term Lombard facility. This facility would allow banks to have unlimited access to central bank credit, provided that borrowings are fully collateralized by government securities. The interest rate on this facility could be tied to the treasury bill rate plus a significant penalty (for example, 5 percentage points) to discourage use of the facility except for emergency liquidity purposes.

CENTRAL DEPOSITORY SYSTEM FOR GOVERNMENT SECURITIES

Current Situation

The CDS is the registry of ownership for treasury bills and treasury bonds and is owned and administered by the BoT. It includes auction functionality and has been designed to coordinate the transfer of securities with the transfer of funds across BoT accounts, thus providing a delivery-versus-payment environment.

All primary dealers are able to open three accounts: one for their own holdings, a pool account for customers' holdings, and a collateral account used for collateralized deals. Also, large investors that are able to bid directly in the auctions have their own accounts, and all other investors have their holdings represented within the pool accounts of primary dealers. An important internal control feature is that each customer's name is represented under the pool accounts, considerably reducing custodial risks.³⁸

³⁸ Custodial risks arise when investors hold securities in subaccounts of the principal book-entry account holders. The main risk is operational, mainly associated with error and fraud on part of the principal account holder.

Physical certificates are issued upon request for a fee of TZS 3,000, but it is unclear as to how many physical certificates are on issue. However, a number of banks and an institutional investor stated that they continue to request certificates. More broadly, there appeared to be a general lack of understanding about the system, and some participants did not know it exists.

The CDS has one major drawback in that securities held in the system are not fungible. That is, securities are maintained in the system in the parcel size in which they were first issued and cannot be broken into smaller parcels. This has obvious consequences for secondary market trading, although it is not the major issue retarding secondary market activity. The buyer and seller complete transfer forms to facilitate transfer of ownership, which can normally be achieved on the same day. In cases involving certificates, they can either be endorsed over to the buyer or surrendered to the BoT when the buyer does not want the certificate.

The Government Loans, Guarantees and Grants Act Number 30 of 1974 was amended in 1998 to specifically recognize the computer-based book entries for securities ownership. This means that full dematerialization of the securities is supported in law.

Policy Issue

The BoT has invested a considerable amount of resources in introducing the CDS and ensuring that it is supported in law. However, the benefits of the system have not been fully realized for two principal reasons. First, securities are not fungible, and second, market knowledge about the system appears to be very low.

Recommendations

- The CDS should be upgraded to facilitate fungibility of securities by allowing the trading of securities in any size and in parcel sizes different from the size in which securities were initially issued. To accomplish this, the book-entry system should be upgraded to allow them to be transferred from one party to another in any amount and in parcel sizes different from the size in which they were first issued.
- Advertise available book-entry system procedures to all banks and phase out the use of physical treasury bill certificates that currently coexist with the book-entry system.

The BoT should ensure that participants in the book-entry system are aware of its operations and particularly its benefits. This could take the form of providing a set of rules to primary dealers governing the operation of the system, as well as providing owners of the securities registered in the system with monthly statements of their holdings to facilitate back-office reconciliations.

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APPENDIX 1. PUBLIC DEBT MANAGEMENT FUNCTIONS IN TANZANIA

MINISTRY OF FINANCE

The primary functions of the MoF in debt management are foreign currency funding and design of debt strategy, participation in DSA, and debt registration, management of the database, and authorization to the BoT for debt servicing:

- The EFD is responsible for external funding negotiations, relationship management with external lenders and donors, and limited monitoring of disbursements and project implementation.
- The PAD is concerned with analytical functions (for example, external debt strategy, future domestic debt strategy, DSA) with shared responsibility for loan evaluation, particularly in terms of its contribution to debt sustainability.
- The AGD is in charge of debt registration, management of the debt database, and authorizing the BoT to make debt-servicing payments.
- The Treasury Registrar is responsible for quantification of contingent liabilities.

BANK OF TANZANIA

Institutional arrangements are further fragmented because the BoT also has important management responsibilities—domestic debt policy design and implementation—and it duplicates some of the MoF functions:

- The Economic Policy Directorate determines policy for domestic debt issuance and analyzes monetary implications of external debt. It implements macroeconomic and monetary programming jointly with the IMF and specifies credit (both public and private sector) consistent with growth and inflation targets, among others.
- The Financial Markets Directorate is concerned with primary issuance of domestic debt.

- The DMD is responsible for registration of foreign and domestic debt, analysis of concessionality conditions upon negotiation of external loans, renegotiation of external debt, and analytical work (for example, the monthly debt profile, portfolio review report, DSA).
- The Banking Department is responsible for debt-servicing payments.

OTHER ENTITIES

Other entities participating in public debt management are involved with projects to be funded and legal work:

- Parastatals and sector ministries identify projects in their respective areas and take part in project evaluation, usually with a consultant, and presentation of projects to the Planning Commission for review at the national level.
- The Planning Commission works with the MoF on identification of viable developmental projects and resource needs, from a national perspective. The commission also participates in funding negotiations.
- The Attorney General Chambers provide legal opinions in debt negotiations and analysis of compliance with the legal framework.

COMMITTEES

Two debt management committees were recently created to coordinate the multiple units and institutions involved in debt management, at both the policy and technical levels:

- The DCC advises the Minister of Finance on policy issues—in particular, financing decisions. The committee is made up of Permanent Secretaries from the MoF, the Planning Commission, the Prime Minister’s Office, the Ministry of Foreign Affairs and International Cooperation, the Ministry of Justice and Constitutional Affairs, and the Governor of the BoT.
- The DMC serves as a technical committee to assist the DCC. It plays a critical role in coordinating information flows and activities across the institutions involved in debt management activities. The DMC is composed of technical members from the same institutions that participate in the DCC.

The DCC and DMC are intended to meet quarterly and monthly, respectively. However, during 1999, meetings were held less frequently. Most of the DMC meetings had been dedicated to discussing new external loan applications, although in January 2001, its agenda broadened to cover debt-servicing and domestic-borrowing issues.

APPENDIX 2. THE TRADING MECHANISM IN AN OPEN-OUTCRY AUCTION

The trading mechanism generally works as follows:

- The auctioneer begins the auction process with an opening price. The opening price could be the price set at the previous auction.
- The floor brokers submit their customers' and their own orders, and the resulting net excess demand or supply is revealed to those present.
- The auctioneer adjusts the price in response to a net excess demand (by raising the price) or supply (by lowering the price).
- Floor traders are permitted to submit new orders (and possibly revisions of old orders) in response to the contemporaneous developments in price and order demand.
- The auction stops at the point where demand and supply are equilibrated—when there are no further orders to buy or sell—and a uniform market equilibrium price is established.

Rules for beginning trading and arriving at the market-clearing price can also vary from system to system. For example, it could be the case that orders are submitted before the initiation of the auction session. The opening price would then be determined on the basis of a price that would achieve the best match (maximum traded volume) between bids and offers.

Table A1: Areas of Responsibility and Decision Making

<i>Area of decision</i>	<i>Unit(s) involved</i>
<i>External debt</i>	
Preliminary project identification, evaluation, and approval at the subnational or ministerial level	Parastatals, regional authorities, sectoral ministries
Project evaluation and approval at the national level, according to national priorities	Planning Commission
Funding negotiation	MoF: External Debt Department, Planning Commission, subnational entities or sectoral ministries, Attorney General
Evaluation of additional funding proposals (Some analysis involves evaluation of the concessionality element using the CS-DRMS.)	MoF Policy Department, BoT Debt Management Department, analysis by the DMC
Further negotiation with potential lenders	Permanent Secretary of the MoF plus all the entities previously engaged in the initial negotiations
Presentation of all funding proposals to the DCC for authorization	DCC
Formalization of the loan contract	Minister of Finance or his or her representative, Attorney General
Approval by Parliament and inclusion in budget	Parliament, MoF Budget Department
Debt registration	The AGD for the MoF, BoT Debt Management Department
Monitoring of project development and compliance with conditionalities	MoF External Debt Department analyzes if conditionalities are met and monitors project development (mostly financial aspects); for physical evaluation, involves parastatals, sectoral ministries, or other relevant entities involved in the project
Disbursements	AGD and External Debt Department of the MoF
Monitoring of project implementation at the national level	Planning Commission
Loan servicing Creating cash cover	AGD authorizes payment for the MoF The MoF passes on cash cover for making

Making the payment	debt payment to the BoT The BoT Debt Management Department checks correctness of debt payment in its own database and makes payments
Debt funding strategy (external)	Proposed by the PAD of the MoF, possibly discussed in the DCC, ultimately the decision of the Minister of Finance
<i>Domestic debt</i>	
Debt funding strategy (domestic)	Proposed by the PAD of the MoF, possibly discussed in the DCC (need for coordination with the MPC of the BoT)
Primary debt issuance policy	MPC
Auction execution	Financial Markets Directorate of the BoT
Debt registration	Financial Markets Directorate of the BoT, DMD of the BoT
Debt servicing	AGD authorizes payment for the MoF, Banking Department of the BoT executes payment