AN ANALYSIS FOR THE EFFECTS OF MONETARY POLICY ON THE DEVELOPMENT OF COMMERCIAL BANKS IN TANZANIA

CASE STUDY OF

CRDB BANK

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DECLARATION

I declare that this research is my original study and to the best of my knowledge and it has never been presented for examination in any other institute of higher learning.

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Signature ....

Date 29/06/09 ....

APPROVAL

This is to certify that this research report presented by Mathew Ernest Mkumbwa entitled:

The effect of monetary policy on the development of commercial banks in Tanzania (Case study of CRDB Bank – Tanga region) has been carried out under my supervision. This research report is now ready for submission to the academic Board of Kampala International University with my approval.

Signature: ....

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BBA,(USA), MSC(UK), ACIS.

Date: 29/06/09

DEDICATION

This research is dedicated to my dear mother Happiness Mkumbwa who through her sacrifice and support she managed to help me reach where I am today. I also dedicate this research to my dear friends Elibariki Mushi, Grace Shahada Gitome and Marco Allute who supported me during my academic period.

God bless you all.

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ABSTRACT

Monetary policy is the process by which the government, central bank, or monetary authority of a country controls the supply of money, availability of money, and cost of money or rate of interest, in order to attain a set of objectives oriented towards the growth and stability of the economy.

Monetary theory provides insight into how to craft optimal monetary policy. Monetary policy rests on the relationship between the rates of interest in an economy, that is the price at which money can be borrowed, and the total supply of money. Monetary policy uses a variety of tools to control one or both of these, to influence outcomes like economic growth, inflation, exchange rates with other currencies and unemployment. Where currency is under a monopoly of issuance, or where there is a regulated system of issuing currency through banks which are tied to a central bank, the monetary authority has the ability to alter the money supply and thus influence the interest rate (in order to achieve policy goals).

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ABREVIATIONS

BOT	Bank of Tanzania
CRDB	Cooperative rural development Bank
BBC	British broadcasting company
EACB	East African currency board
CBK	Central bank of Kenya
BOU	Bank of Uganda
AFCP	Annual finance and credit plan
FEP	Annual foreign exchange plan
BOT	Bank of Tanzania
RFF	Rural Finance fund
ECGF	Export credit guarantee fund
FOMC	Free open market committee
OMO	Open market committee
NBC	National bank of commerce
EXIM	Export and Import bank
NMB	National microfinance bank
SACCO's	Servings and Credit cooperation's

CHAPTER ONE

1.0 Introduction

Monetary policy is entangled in the international payments system a nation uses. The rules of national payments systems are among the pillars that can contribute to the development of commercial banks. Also the concerns of the Central banks and the way they conducts policy have evolved in a long process of trial and error, of which some of those errors were huge and horrendous, and have contributed for the suffering of many commercial banks. This is because Central banks did not acknowledge them for decades hence have led many commercial banks to limp on their feet (Today we call global financial crisis).

Records shows that the economy of the world performed quite well during the 1920s as the Federal reserve bank of United States began to develop the tools of monetary policy which are; the supply of money, Availability of money, and the cost of money or rate of interest.

However some small but vocal group of people advocate for a return to the gold standard (the elimination of the dollar's flat currency status and even of the Federal Reserve Bank). Their argument is basically that monetary policy is fraught with risk and these risks will result in drastic harm to the populace should monetary policy fail. Others see another problem with current monetary policy. The problem for them is not that money has nothing physical to define its value, but that fractional reserve lending of that money as a debt to the recipient, rather than a credit, causes all but a small proportion of society (including all governments) to be perpetually in debt.

Many economists disagree with returning to a gold standard. They argue that doing so would drastically limit the money supply, and throw away 100 years of advancement in monetary policy. Sometimes complex financial transactions that make big business (especially international business) easier and safer would be much more difficult if not impossible. Moreover, shifting risk to different people/companies that specialize in monitoring and using risk can turn any financial risk into a known dollar amount and therefore make business predictable and more profitable for everyone involved. If the Reserve Bank supplies more exchange settlement funds than commercial banks wish to hold, the banks will try to get rid of funds by lending more in the cash market, resulting the cash rate to fall. On the other hand, if the Reserve Bank supplies less than banks wish to hold, they will respond by trying to borrow more in the cash market to build up their holdings of exchange settlement funds; in the process, they will bid up the cash rate.

Some commentator's advocated that if commercial banks are functioning efficiently, then monetary policy is likely to be effective and therefore contribute to the development of a bank.

1.10 Background of the study

In the 19th century a major part of monetary policy in the world consisted of trying to link the currencies to commodities, first to gold and silver, and then, after 1879 to gold. The hope was that these systems would provide automatic stabilization. That hope was poorly realized; economic crises were frequent and sometimes severe. Finally it was decided that the system needed reform after a financial panic in 1907 which was stopped only with bank cooperation organized by J. P. Morgan, the most prominent banker of his time. The result was the Federal Reserve Act of 1913.

Friedman and Schwartz argued that existing views about the cause of the Great Depression were wrong. The Great Depression was not the result of a defect in capitalism or of stock market speculation. Rather, the Federal Reserve (of United States) had allowed the Depression to happen by allowing money stock to decline by 25%.

Even the Federal Reserve, which no longer feels threatened by this interpretation as they still did in the 1960s, now largely, accepts it, and it has influenced monetary policy. From that experience the Federal Reserve will not allow a financial crash or a bank run to reduce money stock as it did in the 1930s. Central banks now react vigorously to such threats, pouring reserves into the banking system if necessary. Examples are evident in the Fed's response to the run on Continental Illinois in 1984, the stock market crash in October of 1987, the liquidity problems of Long Term Capital Management in September of 1998, and the threat of cash withdrawals from the banking system as the result of fears of the so-called millennium bug in January 2000.

In 1936 central banks especially Federal Reserve began to worry about the large level of excess reserves, fearing they might lead to a rash of undesirable bank lending in the future. To forestall this possibility, they raised reserve requirements in 1936 and 1937. The result was a brief but deep recession. Banks held those excess reserves for liquidity, and when the Fed took them away, the banks cut lending in order to restore them. The Fed realized that it was at least partly responsible for this recession and, as a result, a belief developed that although tight money might cut spending, easy money might not increase it. For many years this belief was encapsulated in the statement that one could pull on a string but not push on it.

As the 1930s ended, many central banks doubted that monetary policy was of great importance. Hence, were willing to surrender their independence during World War II to the Treasury Department. Records shows that the economy performed quite well during the 1920s as the central banks began to develop the tools of monetary policy which are; the supply of money, Availability of money, and the cost of money or rate of interest

1.20 Background of the Case study- CRDB Tanga region

CRDB BANK LIMITED is a private commercial bank. The Bank was established on July 1st 1996 to succeed the former Cooperative and Rural Development Bank (CRDB), which was a public institution with majority of shares held by the Government of the United Republic of Tanzania. CRDB has more than 46 branches in Tanzania and more branches are about to be opened. CRDB bank - Tanga, is one of those branches located at the coastal area of Indian Ocean Tanga Urban, at Independence Avenues several kilometers from the city centre - Tanga Region. Services offered are like Deposit accounts, current account, Tembo cards, Personal loans, Transfers & payments, SMS banking, Internet Banking, and Insurance Services. Other business like Current account, Trade Finance, Transfers of payments, Export and import Finance, Interbank Dealings, Share trading, Foreign Exchange and Treasury products are part of the businesses offered by the bank. The mission of CRDB is to "To provide quality and competitive financial services with a strong focus on retail banking and customized corporate and institutional services while ensuring confidence and trust from stakeholders".

1.30 Statement of the problem

Monetary policy in Tanzania is surrounded with many questions because of many setbacks and the output observed at the public. The price to borrow money, the availability and the interests' rate have never been in favor of the consumers thus reduces the effectiveness on development and profits of the commercial banks. The development of monetary policy has been heavily influenced by the trial-and-error experience of policymakers, this has contributed to great losses in commercial banks; also the rules of both national and international payments system have been limiting monetary policy. More over there is great concerns on how the central bank of Tanzania conducts its policy because of its evolvement on a long process of trial and error. Some of those errors were huge and horrendous, and the central bank of Tanzania did not acknowledge them for long. It is however debatable on whether to change the policy when the effects are minimal or there is a need to continue with the policy regardless of minimal effects.

1.40 Objective of the study

1.41 Major objectives

To analyze the effects of monetary policy on the development of commercial banks in Tanzania.

1.42 Specific objectives

- To find possible solutions to improve the process and development of monetary policy in Tanzania.
- To bring awareness to customers and commercial banks on the origin of monetary problems within the country.
- To provide possible solutions to overcome monetary policy problems.

1.50 Research questions

1 What is the impact of monetary policy to the development of commercial banks?

2 What ways can a commercial bank put in place to overcome the problems of monetary policy?
3 What challenges faces commercial banks when trying to implement the monetary policy of the country?

1.60 Scope of the study

1.61 Geographical scope

The research was carried in Tanzania Tanga region with specific reference to CRDB bank (Tanga branches)

1.62 Time scope

The study covered years from 1991 to 2008 considering political changes happened in Tanzania.

1.63 Subject scope

The study explained the impact of the monetary policy towards the development of commercial banks in Tanzania; also examined the challenges faced by commercial banks to implement the monetary policy and the possible solution to development.

1.70 Significance of the study

1. The information will help banks and specifically CRDB to improve and develop possible internal defense mechanisms to overcome the effects of monetary policy in Tanzania.
2. The study will provide advice to the central bank for developing monetary policy so as to bring monetary development in the country.
3. The information will help the researcher to acquire and develop knowledge as well as competence in evaluating the monetary policy of Tanzania.

1.80 Limitation of the study

- ✓ One important limitation of previous research on the reaction of bank lending to restrictive monetary policy is the lack of a direct measure of monetary policy actions. Using a new measure of the timing of policy actions, a re-examination of bank behavior suggests that bank business lending is not constrained by the monetary policy.
- ✓ Another limitation of this study is the time to research on the given topic. The study requires intensive research and extensive grasp of the background as well as enough data.
- ✓ Still a big number of personnel don't have an in-depth understanding of the monetary policy hence hard to get enough information.
- ✓ Lastly, determination of the performance of monetary policy takes a long period of time hence making it hard to determine the effectiveness of the policy within short period of time

1.90 Conceptual frame work

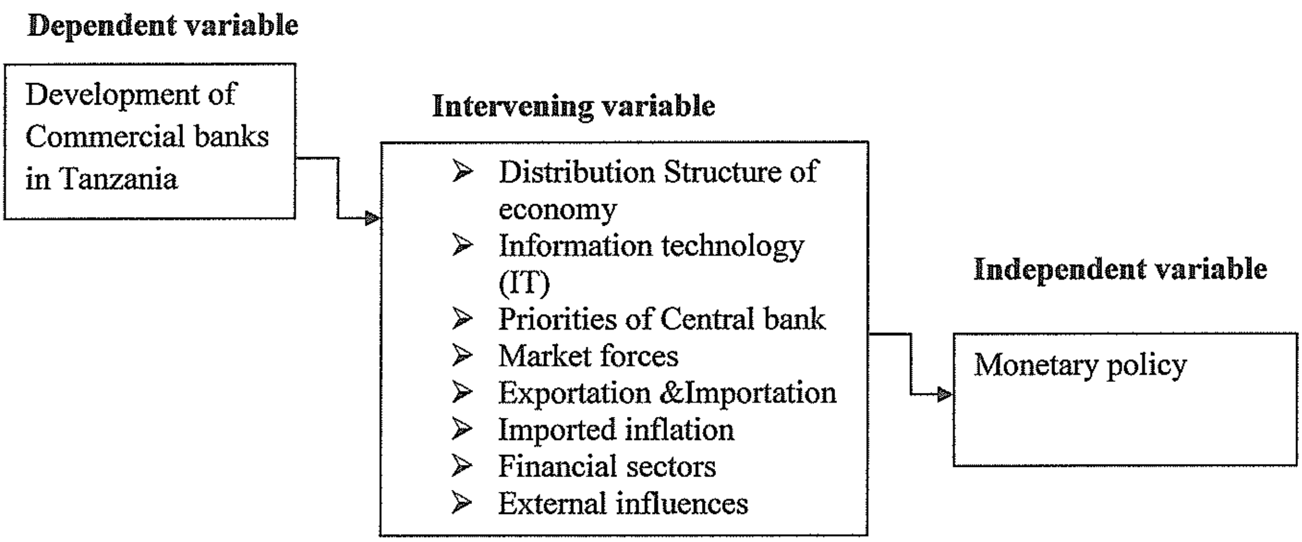
The conceptual frame work helps a researcher to define the topic of the research through the definition of variables which are within the topic. In the conceptual frame work both independent and dependent variables are defined. There are intervening variables which work hand in hand with the independent variables to influence the dependent variables.

In this research the independent variables is monetary policy and the dependent variables is the development of commercial banks in Tanzania. The intervening variables are structure of the economy, Information technology, Central banks priorities, Market forces, Export and imports, financial sectors, and external influences like imported inflation.

The development of commercial banks is influenced by the economic structure example; past experience shows that the state control economy regime in Tanzania results in inefficiency in resource allocation. More over the market has the ability to determine the cost of funds more efficient and avoid prohibitive / restrictive policies, which impair effective utilization of resources. The central bank's strategy has some direct influences to the development of commercial banks because of its ability to push up intermediate costs example the structural bottlenecks. The financial sectors and the trends of its activities as well as the employee's performance also influence the development. Other factors like external interference, imported inflation and the level of exportation also affects the development of financial flow in the commercial banks. More over the application of Information Technology into daily activities can speed up the development of commercial banks; example modern security systems, quick money transfer and computerized systems which maintains the network for 24 hours.

The conceptual framework can be illustrated using the following diagram

Conceptual Modal



The conceptual frame work then leads us to the topic which states:

THE EFFECTS OF MONETARY POLICY ON THE DEVELOPMENT OF COMMERCIAL BANKS IN TANZANIA

Case Study: CRDB BANK – TANGA

1.91 Definition of key terms

Policy: Is a course of action or a program of actions adopted by a person, group, or government, or the set of principles on which they are based. Policy is made by people who have goals and who must calculate how best to achieve those goals given the environment they face.

Money: a medium of exchange issued by a government or other public authority in the form of coins of gold, silver, or other metal, or paper bills, used as the measure of the value of goods and services. Money is the stock of assets used to conduct transactions. The most important function of money is that it acts as a medium of exchange where people use money for purchases and sales of goods and services. Money is then whatever is accepted and used for transactions.

Monetary policy is the process by which the government, through the central bank, or monetary authority of a country controls the supply of money, availability of money, and cost of money or rate of interest, in order to attain a set of objectives oriented towards the growth and stability of the economy.

Monetary base; Is the total amount of a currency that is either circulated in the hands of the public or in the commercial bank deposits held in the central bank's reserves. This measure of the money supply typically only includes the most liquid currencies.

CRDB Is a credit development bank which undertakes all financing and banking activities usually owned by shareholders.

Bank reserves: Is the financial assets of bank where all cash and deposits a bank has to keep in reserve: or the cash and deposits that a bank is required to keep at a central bank to meet the required reserve ratio.

Federal Reserve; is a central banking system of the United States, popularly called the Fed. It is a central bank serves as the banker to both the banking community and the government.

CHAPTER TWO

2.0 Literature Review

2.10 Introduction

Monetary policy abounds in today's society. Many People seem not to recognize the implication or the effects of the policy to the economic performance of banks and individuals. The practice of central bank to regulate the supply of money, availability and the cost of money or rate of interests is what is called monetary policy. Formally each country has its approaches to monetary supply depending on the market structure of that country.

Recent research on a bank credit channel has focused on two questions.

1. Are certain borrowers so dependent on bank lending that any change in banks' willingness to lend immediately affects investment and spending decisions?
2. Do monetary policy changes directly constrain bank lending?

Both conditions are necessary for bank lending to play a special role in the monetary transmission mechanism. Thus far, research on a credit channel has yielded mixed results. Some recent research provides support for the view that certain borrowers, such as small businesses, are very dependent on banks for financing. This finding suggests that disruptions in bank credit could affect economic activity. At the same time, there is conflicting evidence that bank lending is directly constrained by monetary policy.

2.20 History of monetary policy

Monetary policy was primarily associated with interest rate and credit and for many centuries there were only two forms of monetary policy that is decisions about coinage and decisions to print paper money to create credit. Interest rates, while now thought of as part of monetary authority, were not generally coordinated with the other forms of monetary policy during this time. Monetary policy was seen as an executive decision, and was generally in the hands of the authority with senior age, or the power to coin. With the advent of larger trading networks came the ability to set the price between gold and silver, and the price of the local currency to foreign currencies. This official price could be enforced by law, even if it varied from the market price.

In 1694 the bank of England acquires the responsibility to print notes and back them with gold which provide a pave way for the idea of monetary policy to be an independent executive action. Governments only began issuing paper money in Europe in the eighteenth century. An early example was Sweden's note issue to finance its participation in the Seven Years War (Eagly 1969). Flat money reached its maturity during the American Revolutionary wars when the Congress issued continentals to finance military expenditures. They were promissory notes to be convertible into specie but the promise was not kept and they were issued in massive quantities. However the rate of issue and the average inflation rate of 65% per annum (Rockoff 1984) was not far removed from the revenue maximizing rate of issue by a monopoly flat money issuing central bank of the twentieth century (Bailey 1956.). During the French revolution, the over issue of paper money and the assigners based initially on the value of seized church lands led to a hyperinflation (White 1995), (BBC. March 31, 2006). The goal of monetary policy was to maintain the value of the coinage, print notes which would trade at par to specie, and prevent coins from leaving circulation. The establishment of central banks by industrializing nations was associated with the desire to maintain the nation's peg to the gold standard, and to trade in a narrow band with other gold-backed currencies. To accomplish this end, central banks as part of the gold standard began setting the interest rates that they charged, both their own borrowers, and other banks that required liquidity. The maintenance of a gold standard required almost monthly adjustments of interest rates.

During the 1870-1920 periods, the industrialized nations set up central banking systems with one of the last being the Federal Reserve in 1913 (Milton Friedman 1960). By this point the role of the central bank as the "lender of last resort" was understood. It was also increasingly understood that interest rates had an effect on the entire economy, in no small part because of the marginal revolution in economics, which focused on how many more, or how many fewer, people would make a decision based on a change in the economic trade-offs. It also became clear that there was a business cycle, and the economic theory began understanding the relationship of interest rates to that cycle. Research by Cass Business School has also suggested that perhaps it is the central bank policies of expansionary and contractionary policies that are causing the economic cycle; evidence can be found by looking at the lack of cycles in economies before central banking policies existed.

Monetarist macroeconomists have sometimes advocated simply increasing the monetary supply at a low, constant rate, as the best way of maintaining low inflation and stable output growth. However it prove failure in 1979 according to United States Federal Reserve chairman Paul Volker who advocate that, 'the policy was impractical because of unstable relationship between monetary aggregates and other micro economic variables' (Ben Bernanke 2006)

Therefore monetary policy decisions today take into account a wide range of factors such as short term interest rates, long term interest rates, velocity of money through the economy; exchange rates, credit quality, bonds and equities (corporate ownership and debt), government versus private sectors, spending/savings, international capital flows of money on large scales and financial derivatives such as options, swaps, and futures contracts.

2.30 The history of monetary policy in Tanzania

The evolution of monetary policy in Tanzania dates back to 1919, when the East African Currency Board (EACB) was established by the British colonialists. The major objective of the EACB was to supply and control currency in East Africa, following growth in commercial banking in the region. The EACB aimed at automatic improving against pound sterling. In this regard currency was covered in pound sterling for the reserves. It was also agreed that there would be no profit distribution until the desired level of reserves had been achieved.

The EACB had two main achievements;

1. Ensured the continuous convertibility of the shilling, a factor which created confidence in the currency and the economy as a whole.
2. There was no room for inflationary financing as the money supply was strictly tied to foreign assets. However, given that the money supply was strictly tied to foreign assets, the EACB failed to expand domestic credit to stimulate investment in and hence the growth of

the domestic economy. Similarly, the fact that the domestic money supply was tied to foreign assets implied that foreign trade governed the domestic money supply.

3. There was also a lack of monetary sovereignty for the East African states which actually had different levels of economic development.
4. The high cost of holding high levels of sterling reserves by the poor East African states, was also another serious shortcoming of the currency board arrangement in East Africa.

Following the independence 1961 it was recommended that the EACB to be converted to East African central bank and the individual countries to establish smaller country central banks. Instead governments decided to establish individual central banks and the three central banks namely the bank of Uganda (BOU), the central bank of Kenya (CBK) and the Bank of Tanzania both established in 1966.

Establishment of the bank of Tanzania 1966 gave the bank mandate to work on the monetary policy indirectly, using instruments like; the annual Finance and Credit Plan (AFCP), which targeted specific levels of credit growth to different sectors of the economy, to be attained through administered interest rates. And the annual Foreign Exchange Plan (FEP), which tried to match the demand and supply for foreign exchange.

Owing to development problems the Bank of Tanzania (BOT) Act was amended 1978 which enabled the BOT to advise the government and financial institutions on matters pertaining to credit for agricultural development. Similarly, special funds were created to facilitate the attainment of developmental goals. The funds included the Rural Finance Fund (RFF), which was used to finance rural development, including the guaranteeing of loans to the agricultural sector and also a refinancing facility for banks which lent money to agriculture. The Industrial Finance Fund (IFF) was also established to promote industrial development, and the Export Credit Guarantee Fund (ECGF) was used to promote exports, through guaranteeing exports. More over The Capital and Interest Subsidy Fund was used to subscribe to the share capital of development finance institutions like commercial banks and to provide interest subsidy to these institutions.

The policies implemented immediately after 1978, led to rapid growth in the money supply, mainly caused by central bank accommodation of the government and commercial banking lending to government-owned institutions (Joseph L.M 1995)

2.31 What is monetary policy?

Monetary policy is the process by which the government, central bank, or monetary authority of a country controls the supply of money, availability of money, and cost of money or rate of interest, in order to attain a set of objectives oriented towards the growth and stability of the economy (Federal Reserve board 2006).

Monetary policy is referred to as either being an expansionary policy, or a contractionary policy, where by an expansionary policy increases the total supply of money in the economy, and a contractionary policy decreases the total money supply. Expansionary policy is traditionally used to combat unemployment in a recession by lowering interest rates, while contractionary policy involves raising interest rates in order to combat inflation. Monetary policy is contrasted with fiscal policy, which refers to government borrowing, spending and taxation (B.M. Friedman (2001))

2.32 Goals of monetary policy

According to the Bank of Tanzania, (2001 Monetary Policy Statement), the primary goal or objective of monetary policy in Tanzania is to formulate and implement monetary Policy, directed to the economic objective of maintaining price stability, conducive to a balanced growth of the national economy. Other objectives are:

- To improve growth through exportation
- To promote stability in prices and maintenance of full employment
- To maintain the exchange rate to that of dollar
- Adequate reserves to facilitate imports, debt repayment and intervention
- Promotion of financial development
- Realistic interest rates (at least above inflation)
- Increase in credit consistent with growth and money supply target

2.40 Functions of central banks

The formal functions of the central bank include the following:

1. Approve bank mergers.
2. Set the regulations that determine what activities commercial banks are allowed to engage in.
3. Set reserve requirements and approve changes in the discount rate.
4. Direct open market operations through the free open market committee (FOMC).

2.50 Monetary policy instruments/tools

The monetary policy tools are the basic devices that aids in accomplishing a task of controlling the cash flow in the system or circulation. Majorly there are three monetary policy instruments; these are,

- Open market operations
- Reserve requirements
- The 'Discount Window' (Interest rates)

The Bank of Tanzania uses indirect instruments of monetary policy, implying that central bank operations are used to influence money supply indirectly. These instruments include open market operations (OMO), reserve requirements, discount policy, foreign exchange market operations, repurchase agreements, moral suasion and gentlemen's agreements. These instruments affect the supply of money through changing either the stock of reserve money or the money multiplier. (Bank of Tanzania, 1997)

2.51 Reserve Requirements.

Reserve requirements influence the ability of banks to create new loans which affect the broader aggregates. According to the (Federal Reserve), the reserve requirement is the least used policy where a bank is required to keep a minimum percentage of its deposit either as cash or on deposit at the central bank. The reserve requirement has no impact on the monetary base but restrict the ability of the bank to lend thus influences the broader aggregates. Monetary policy can be used to create the demand for goods and a bank service by increasing the interest rates through increase in inflation hence drives up services or wage prices and causes the Interests rates to increase.

A central bank can increase the reserve ratios which might lead to a reduction in lending; this lowers the demand for hard currency, the opposite would also obtain. The reserve requirement set in Tanzania is at 10% (Bank of Tanzania 2001 report).

2.52 Interest rates / discount window

Interest rate is the price a borrower has to pay to enjoy the use of cash which he/she does not own, and the return a lender enjoys for deferring his/her consumption or parting with liquidity. This rate can be analyzed in the normal framework of demand and supply. In a controlled economy whereby prices are not freely determined, interest rates are normally regulated by the central bank.

There is general agreement among economists and policymakers that monetary policy works mainly through interest rates (Hubbard, R. Glenn. 1994). When policy is tightened through a decrease in reserve provision, for example, interest rates rise. A rise in interest rates leads to a reduction in spending by interest sensitive sectors of the economy, such as housing and consumer purchases of durable goods (Jaffee & Dwight M. 1971). More recently, a second line of research termed the "credit view," or "lending view," has explored how credit market imperfections may not only create a credit channel for monetary policy, but also may make disruptions in credit availability a source of fluctuations in economic activity (Bernanke and Blinder 1988). As in the availability doctrine, this approach emphasizes that changes in monetary policy may work partly by directly affecting the supply of bank loans.
The Central Bank has the power to announce the maximum or minimum rates of interest and charges that commercial banks may impose for specific types of loans, advances or other credits and pay on deposits. However, the Bank has opted not to use this as a tool of monetary policy

but to let market and competitive forces determine interest rates. BOT Governor Prof. Benno Ndulu said that "under the prevailing market-oriented economy, the Bank of Tanzania will maintain market-determined interest rates rather than directly regulate rates set by commercial banks in the country, regulation of the interest rates of commercial banks may lead to imperfect pricing of financial instruments, hence inappropriate allocation and utilization of resources. In most cases of controlled economies where central banks do regulate interest rates of commercial banks, the final result is usually ineffective (THISDAY Thursday, January 15 2009).

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2.53 Open Market operation

Open market operations are one of the most used instruments in monetary policy. The central bank can purchase or sell the treasuries to the brokers hence alters the supply of bank reserve ratios. This lead to the direct control of the quantity of none borrowed reserves in the banking sector. Currently the open market operations are the primary policy tools of the central banks. Through open market operation the reserve ratio of the banking sector increases (Federal Reserve report).

2.54 Supply of money

Supply of money refers to the total amount of money available in an economy at a particular point in time. Some economic scholars advocate that a country should commit itself to particular cause of action like rules to supply money while others advocate for discretional or cost rule policy. The rule policy is easy to forecast and has less uncertainty where as the fixed policy rules allow the possibility of exploitation of monetary policy rule for profit. Fixed supply of money promotes stability of prices in long run hence the average rates of inflation. Higher monetary supply promotes rapid income growth and productivity which raises the consumer spending thus serving falls. More over Increase in monetary supply lowers interest rates thus pushes the economy back to capacity, however to a bank it is a loss since saving decreases, while to the investment spending sector it is a gain (FIN 30220).

(Book rags, Inc 2002-2006) advocate that if the Reserve Bank supplies more exchange settlement funds than commercial banks wish to hold, the banks will try to get rid of funds by lending more in the cash market, resulting the cash rate to fall. On the other hand, if the Reserve Bank supplies less than banks wish to hold, they will respond by trying to borrow more in the cash market to build up their holdings of exchange settlement funds; in the process, they will bid up the cash rate.

The main debate amongst economists in the second half of the twentieth century concerned the central banks ability to predict how much money should be in circulation, given current employment rates, and inflation rates. Some economists like Milton Friedman believed that the central bank would always get it wrong, leading to wider swings in the economy than if it were just left alone (Milton Friedman (1962)). This is why they advocated a non-interventionist approach.

Chairman of the U.S. Federal Reserve, Ben Bernanke, has suggested that over the last 10 to 15 years, many modern central banks have become relatively adept at manipulation of the money supply, leading to a smoother business cycle, with recessions tending to be smaller and less frequent than in earlier decades, a phenomenon he terms "The Great Moderation" (FRB: Speech, Bernanke-The Great Moderation-February 20, 2004)

2.60 Bank portfolio behavior

One approach to identifying a bank lending channel is to see how banks alter their assets and liabilities during periods of monetary restraint. Accordingly, a number of studies have examined how banks adjust loans, securities, and deposit and non deposit liabilities to changes in monetary policy. Several stylized facts about bank portfolio behavior have emerged from this line of research (Bernanke and Blinder 1992; Romer and Romer 1990).

2.70 Bank credit and monetary policy

If bank lending plays a central role in the monetary transmission mechanism, changes in bank lending practices or in the role that banks play in financial markets can alter the transmission mechanism and have important policy implications. Charles S, Morris et.al, (1995) advocate that two institutional changes that may have affected the transmission mechanism are the secular decline in bank lending to business and the growing use of bank loan commitments. Also for monetary policy to operate through a credit channel, not only must there be bank dependent borrowers, but monetary policy must also directly affect banks' willingness to lend. To determine whether monetary policy affects bank lending, some studies have examined how banks adjust their portfolios in periods of monetary tightening, while other studies have looked at changes in the price and non price terms of lending.

CHAPTER THREE

3.0 Methodology

3.10 Introduction

This chapter indicates the methods a researcher put in place to generate, analyze, and report the findings. Data collected will test and evaluate the validity and reliability of results, and finally helps a researcher to draw the conclusions from them. This chapter makes clear the reasons to why a particular method or procedure is used, the consistency and the accepted practice in the field of study. The questionnaires and interviews offer respondents a reasonable range of answers to choose from. The analysis stick to the objectives of the study, discuss the problems that were anticipated, explain the steps taken to prevent them from occurring, and the problems that did occur and the ways their impact will be minimized. The study analyzes the effect of monetary policy to the development of commercial banks in Tanzania as well as providing the possible solutions for the problems.

3.20 Research design

This research used qualitative as well as quantitative methods of data collection and analysis. Quantitative method determine the number of respondents, while qualitative methods gives detailed descriptions and explanations of the phenomenon studied rather than providing and analyzing statistics. Also the information to be collected took a cover of information from 1991 to 2008.

3.30 Study population

The study chooses CRDB bank employees and clients as eligible for interview as well as studying Tanga branches. The choice provided in-depth knowledge and information about the effects of monetary policy, because of its long survival in the business and the seniority. CRDB has acquired a title as the first commercial bank to be established in Tanzania.

3.40 Sample technique

A simple random technique sampling method was adopted. Also a sample of 100 questionnaires and interview of at least 25 members of staff was administered on a random basis to the selected branches of CRDB.

3.50 Sample size

A size of 25 respondents was used to determine the traditional sampling statistical formula. The above sample made the level of confidence a bit higher. From each cluster of interviews, the respondent was chosen randomly.

3.60 Data collection

Questionnaire and interviews was used as a method of collecting data. Random samples face interview and observation was considered for the purpose of comparison.

3.70 Source of data

3.71 Questionnaires

Questionnaires were used to obtain the information and to test whether there is any connection between monetary policy and the development of the bank. This helped a researcher to obtain the following information;

1. To find possible solutions to improve the process and development of monetary policy in Tanzania.
2. To come up with clear methods of analyzing the monetary policy in Tanzania.

3. To bring awareness to customers and commercial banks to understand deeply the origin of monetary problems within the country and how to overcome possible setbacks as a result of poor monetary policy.

3.72 Data from CRDB

CRDB data were used to determine the effects of monetary policy to the development of commercial banks over last 12 years from 1996 – 2008.

3.73 Interviews

The interview helped to compare CRDB with different financial institutions which are competing within Tanzania market. Interview includes NBC bank, NMB, EXIM and Barclays bank of Tanzania.

3.80 Data collection and data analysis technique

Data was collected for both primary and secondary sources. Primary data was collected using questionnaire and interviews while secondary data was obtained from public periodicals and journals from the public.

3.81 Questionnaires

The questionnaires targeted the professional workers in the banking sector who are well equipped with monetary policy issues.

3.81 Data presentation

Data presentation is in the form of graphs, pie charts, tables, and pictures where necessary. Data presentation will provides a clear view of the information given by the respondents hence help a researcher to draw conclusion from them.

3.90 Research procedure

A researcher obtained recognition letter from Kampala international university, faculty of business and management to CRDB bank to allow the study to be conducted.

CHAPTER FOUR

RESEARCH FINDINGS, PRESENTATIONS, ANALYSIS AND INTERPRETATION

4.0 Introduction

This chapter deals with the facts, evidence, analysis of data, evaluation and discussion of findings, all well structured according to the data obtained by means of interview as well as the simple questionnaire and observations. The documentary materials are recorded and analyzed into tables. After the analysis, all data are interpreted into simple forms of percentage as responded by the respondents.

4.10 Education level of respondents

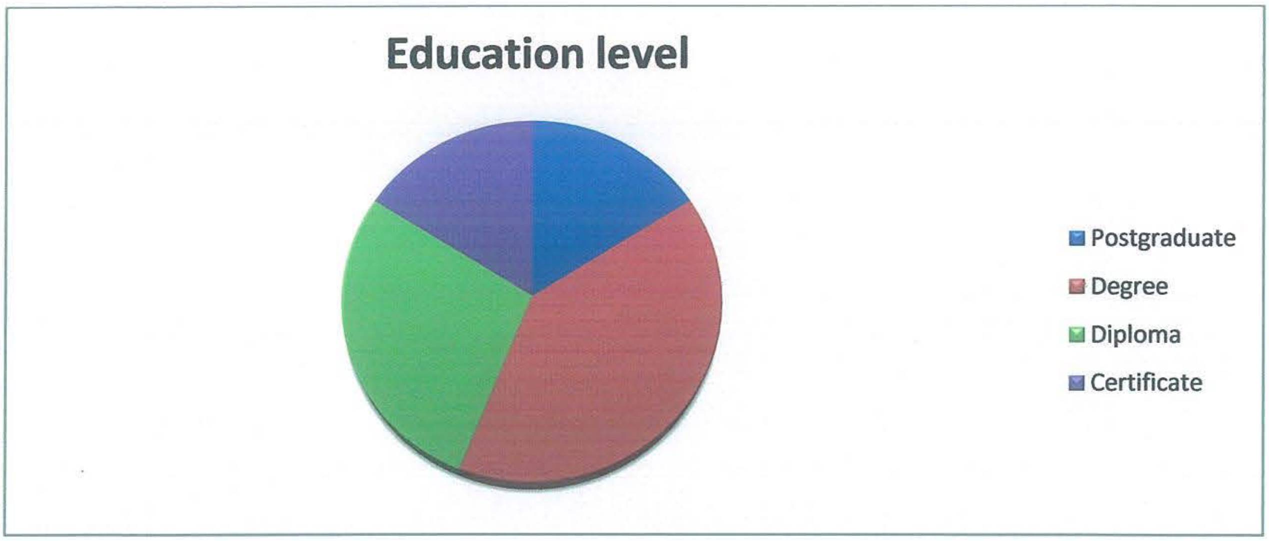
Table 1.0 Education level of respondents

Qualification	Frequency (f)	Percentage (%)
Postgraduate	4	16
Degree	10	40
Diploma	7	28
Certificates	4	16
A-Level	0	0
O-Level	0	0
Total	25	100

Source; Researcher

The study reveal that (40%) of the respondents are degree holders, 16% postgraduate, 28% diploma and 16% certificate. This shows that a large number of respondents are literate hence the information given is reliable to the researcher.

Figure 1 Education distribution of respondent



Source; Researcher

4.20 Employee's level of understanding on monetary policy

Table 2.0 Employee's literacy level on monetary policy

Literacy level	Number of respondent	Percentage (%)
High (Yes)	22	88
Minimal (Some how)	3	12
Low (No)	0	0
Total	25	100

Source; Researcher at CRDB Bank

The study shows that 88% of the respondents understand the meaning of monetary policy at the highest level, while 12% have a minimal level of understanding and no respondent shows incompetence on the knowledge of the monetary policy. This means that the knowledge can trigger respondents to release relevant information.

4.30 Interest rates and bank performance

Table 3.0 Response on the interest rates

Types of answers	Number of respondent	Percentage (%)
Moderate (YES)	6	24
High (NO)	17	68
Not aware	2	8
Total	25	100

Source; Researcher at CRDB bank

The above analysis shows 68% of the respondents agree that the interest rate charged by the bank is high and does not favor customers or their businesses, while 24% argued that the interest rate is normal to their businesses while 8% argued that they are not aware whether the rate is conducive to the businesses or not. The analysis shows that the bank is at a greater risk of loosing many borrowers as a result of high interest rate in the future; Interview shows that many customers are looking for an alternative source to get cheap loans with low interest rates. This imply that the bank can loose some borrowers in the future incase a competitor arise. Therefore the profits might be affected.

4.40 Reasons for high interest rates

The central bank's interest policy does not favor commercial banks to gain profit at the lowest interest rates, therefore for a bank to be on a safe side it has to insert higher rate to be able to repay back loans and maintain the reserve ratio required by the central bank. This may result into growth slow down as well as customer decline in the future.

From questionnaires 68% of the respondents argued that they are uncomfortable with the loans interest rates; this implies that changes should be done to regulate the rates for small borrowers to be encouraged to borrow money.

4.50 Performance of monetary policy and development of commercial banks

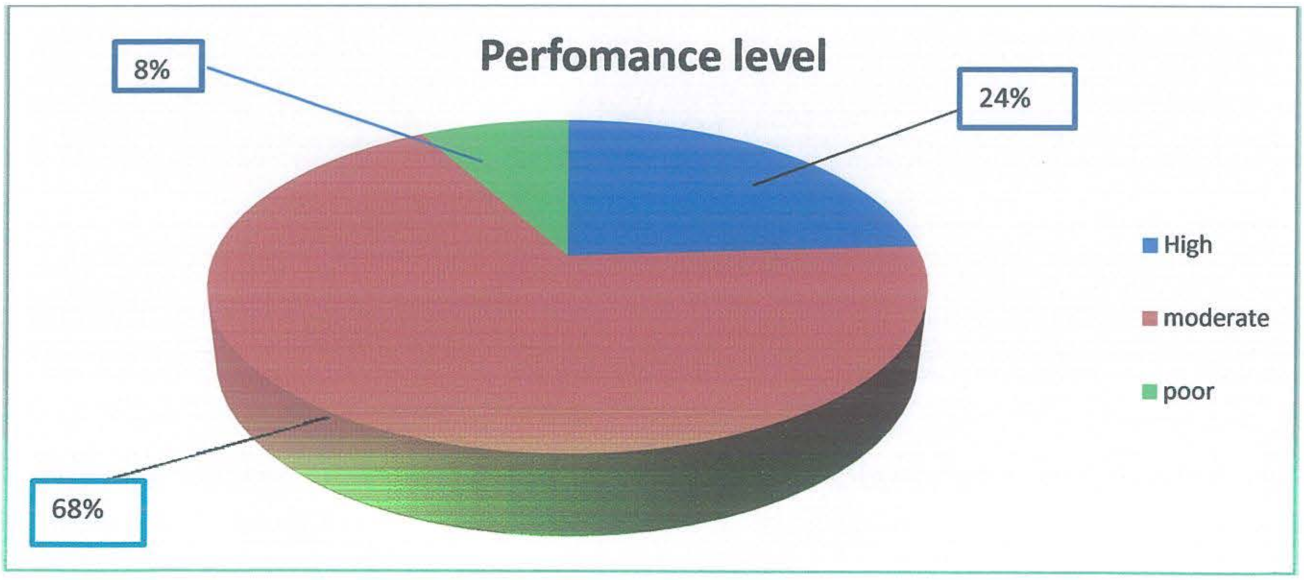
Table 4.0 Response on the performance of monetary policy in Tanzania

Types of answers	**Number of respondent**	**Percentage (%)**
High performance (fair)	6	24
Moderate performance	17	68
Poor performance (Unfair)	2	8
Total	25	100

Source; Researcher at CRDB Bank

68% argued that the performance is moderate, 24% advocate for the higher performance and 8% advocate for poor performance of the monetary policy. This shows that the economy is moderate however there is a need to improve the policy to reach to the level where resources will be utilized effectively and hence improve commercial banks.

Figure 2 Response on performance of the Tanzania Monetary policy



Source; Researcher

4.60 Reserve ratio and bank growth

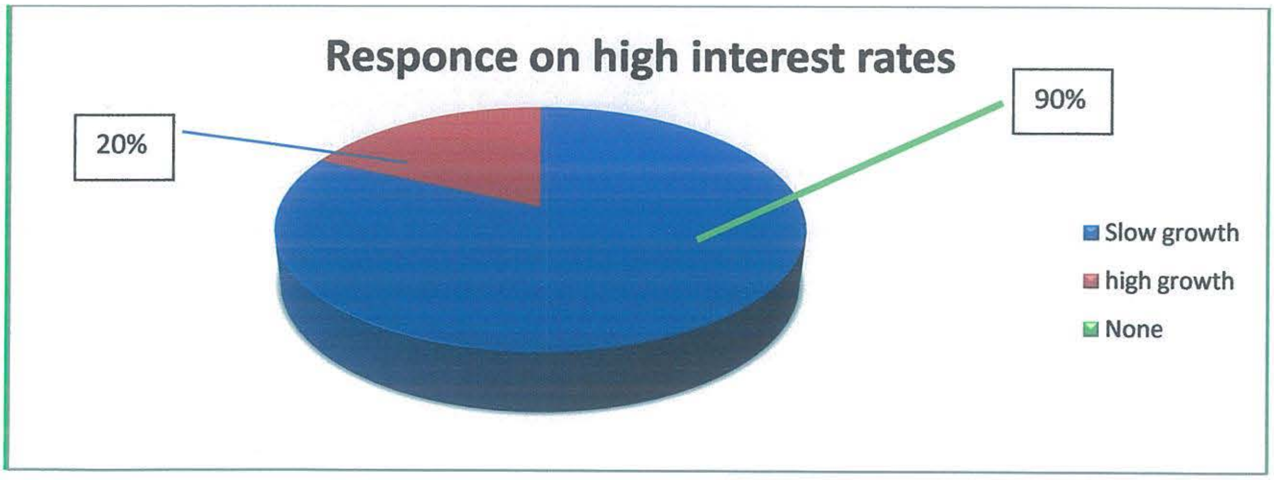
Table 5.0 Effects of reserve ratio on development of commercial banks

Types of answers	**Number of respondent**	**Percentage (%)**
Moderate (YES)	20	90
High (NO)	5	10
Not aware	0	0
Total	25	100

Source; Researcher

Response shows 90% of the commentators argue that when the reserve ratio is high it will contribute to the slow growth of financial sectors, while 10% said it won't affect the growth due to some adjustments a bank would make. This brings a researcher to the theory that; when the central bank increases the amount a bank is required to keep on hand as a percentage of its deposits, commercial banks are forced to make fewer loans. Therefore the economy will be having fewer producers who bring return to the bank as deposits. Therefore slow growth will be experienced in the bank as a result of fewer deposits.

Figure 3 Response on the effect of high interest rates in a bank



Source; Researcher

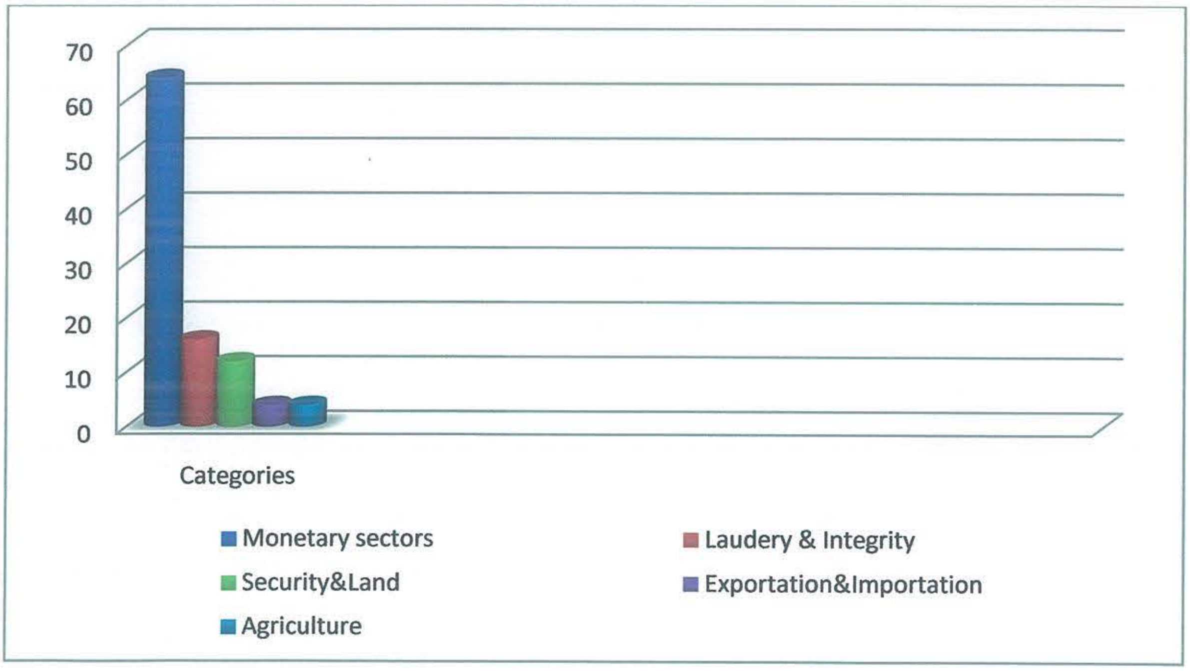
4.70 Recommendation to the central bank of Tanzania (BOT)

Table 6.0 Recommendation to the central bank

Monetary Policy on sector/Institution to be improved	Number of respondents	Percentage (%)
Loan Interest rates	16	64
Money laundering	04	16
Security/Land policy	03	12
Exportation and Importation	01	04
Agricultural sectors	01	04
Total	25	100

Source researcher

Figure 4 Recommendations on different categories



Source researcher

64% of the respondent's comments advocate on the interest rates as one of the instrument of monetary has greater effects on the development of commercial banks. 4% comment on Export and imports, 4% Agriculture, 12% Security/Land and 16% for Laundry and Integrity. This implies that monetary policy of Tanzania has greater impact on the development of commercial banks compared to other factors which influence development.

CHAPTER FIVE

SUMMARY, RECOMMENDATION AND CONCLUSION

5.0 Introduction

This chapter contains the summary of the main findings of the study recommendation and conclusion. These findings were based on the research questions and objectives. The main sources of data were employee's managers and former bank officers who had an experience on the monetary policy. Questionnaires and Interviews were the main source of data collected. These data were coded and presented into charts and tables by using frequencies, diagrams and percentages to give a clear view of the results.

5.10 Summary of the findings

According to the research I carried the Tanzania monetary policy was found to have many weaknesses which affect the general performance of the commercial banks hence provide a loop holes for commercial banks to loose customers.

The government has tried its best to come up with economic reform program from 1991, since then the monetary policy has been improved from one level to another however improvement is required. From the research findings the following was observed;

Reserve requirement ratio; when the central bank increases the amount a bank is required to keep on hand as a percentage of its deposits; it forces commercial banks to make fewer loans. This causes a drop in the money supply since the money multiplier falls. By so doing a bank looses some expansionary opportunities which might come as a result of offering more loans. Also, lowering reserve requirement means that banks make more loans and the money supply is higher hence banks have some opportunities to expand its operations and expansion. In practice, the central bank of Tanzania changes reserve requirements very infrequently, maybe once in ten years. Findings show that when policy is tightened, both total loans and business loans at small banks fall, while loans at large banks are unaffected. The differential response of small banks may indicate that; they have less access to alternative funding sources than large banks and so are less able to avoid the loss of core deposits when policy is tightened. This policy instrument is very crude because it produces huge changes in money supply.

Discount rate; this is the interest rate which a bank must pay the central bank of Tanzania (BOT) when the bank borrows money from the central bank. The more money a bank borrows, the more it can loan out and the more it increases the money supply. From the observation of opinions; when the central bank decreases the discount rate more banks will want to borrow money, thus increasing the money supply and development. The reverse is true when the central bank decides to increase the discount rate; However this is the worst part of it where a commercial banks have to put the higher interest rates to borrowers so as to be able to repay the money back to the central bank ; the effects is that many customers will fear to borrow money. Central bank of Tanzania changes the discount rate several times a year, and the direction of the change is viewed as a signal about the type of monetary policy pursued. Banks avoid borrowing from this "last resort" source because of fear to be audited as the central bank inquires why the bank could not borrow somewhere else.

Open market operations are most frequently used as a tool of monetary policy. The term refers to the Central bank activity of buying and selling government securities from commercial banks or from the public. The agency in charge is called the "Open Market Committee of the central bank" because it buys and sells government bonds on the open market. The central bank of Tanzania does not issue government bonds, but only trades them to fine tune the money supply. Government securities are a major source of risk-free interest income for the Central bank. During recession, the Central bank can stimulate aggregate demand by increasing the money supply. To put more money into circulation, the central bank buys bonds from people, businesses or banks that hold them.

\This is the risk free method which gives freedom a bank either to sell, not to sell, buy or not to buy to the central bank. From the observation this policy seems more suitable to commercial banks as it gives freedom for commercial banks to either sell or buy bonds and thus expands its assets or maintains its operations at the rate they want.

The following weaknesses were founded in Tanzania monetary policy and these are as follows;

- **Weak monetary policy transmission mechanism**

The transmission of monetary policy in Tanzania is still weak due to the structural impediments in the economy which hinder the development of an efficient financial system. Weakness in the legal framework, coupled with a high risk level in the economy, has impacted negatively on monetary policy transmission.

Poor payment system

The payment system in Tanzania is still at the lower level of development, with a high level of the money supply being tied up in the payment system, without a clear monitoring of such funds. This phenomenon has led to large amounts of money not being involved in the production of goods and services and instead enters into the hands of few people for personal interests. The Bank of Tanzania (BOT), in collaboration with the banking system, has initiated the National Payment Systems Development Project, which aims at developing the current payment systems into a modern and efficient payment system. A special unit, charged with this responsibility, has been established at the Bank.

- **Weaknesses in the current monetary policy framework**

Frequent changes in the money multiplier and instability in the velocity of money has affected the Central bank's ability to attain the projected level of the intermediate target as well as the final objective for monetary policy.

- **Unpredictability of some sources of growth in base money**

Unexpected government actions and unanticipated foreign exchange inflows cause deviations from the projected and the actual liquidity levels in the economy and hence difficulties in attaining monetary objectives. One of the current problems which have affected almost the whole world is the global financial crisis where by lack of liquid money has courses our reserves to be in dilemma. Many financial institutions do not have enough funds to provide loans to consumers and because of that the rate of interest has grown high.

5.20 Conclusion

The study has shown that the number one effect of monetary policy affects borrowers due to highest interest rates. Therefore commercial banks can not expand comfortably, and because of high interest rates, there is a danger for many borrowers to run away from borrowing to the commercial banks. Other financial institutions which are not regulated directly by the central banks Example Servings and Credit Co-operations (SACCOs) are mostly likely to gain customers. Despite the fact that some monetary policy like interest rates are market determined, the central bank seeks to attain a level of interest rates, which is consistent with the fundamentals of inflation. Therefore there is a need for the commercial banks experts to be involved in decision making to allow collective idea generations and problem solving.

5.30 Recommendations / Possible solutions

Different recommendations were offered as part of data collected in order to develop the commercial banks in connection to the monetary policy of Tanzania. These are;

a. The land policy should be improved to allow people to borrow using their land assets (Loan Securities) 16% of commentators advocate that.
b. The Central bank of Tanzania has to make loans interest rates at a reasonable rate as well as controlling the interest rates on small financial institution like SACCOs, in order to monitor balance on financial institution sectors.
c. Bureaucracy has to be prevented to quicken the activities of the commercial banks (16%).
d. Commercial banks should omit other unreasonable fees to allow many borrowers to benefit from loans as well as establishing the credit guarantees (64%)
e. Dollarization should be restricted, budget and priority development on expenditure, closer controlling of foreign direct investments and capital flights especially profits, as

well as waive tax on exports. All these will help the reserve ratio to be in a good condition hence money supply will be improved.

f. There should be involvement of commercial banker's executives, or professionals in the process of making decisions concerning monetary policy at the central banks. This will help all to express their opinion as well as business experience.

g. There should be a culture to amend the policy to comply with the global economical changes, as well as structuring the policy to be flexible to suit the current environment (68% advocates for improvement of monetary policy). Moreover the central bank should set its policies basing on the available resources.

h. Money laundering and corruption should not be entertained to promote transparency and integrity at the central bank.

5.40 Areas for further research

The global financial crisis has brought a new challenge through out the world as the giant Nations struggles to restore their economy there is an induction effects to other commercial banks all around the world. How can a central bank of Tanzania withstand the effects if there is interconnection of global economy due to globalization effects? And how can a commercial bank defend itself from collapsing if the central bank fails to counter attack the external factors which affect its monetary policy? All these questions point out a great need for further research to the defensive mechanisms a commercial bank can put in place to overcome external threats.

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APPENDICES

APPENDIX 1

Questionnaire

(Tick where appropriate inside the box)

01. What is your occupation?

a. Employer based ☐
b. Self employed ☐
c. I don't have a job ☐

02. What is your qualification?

....

03. Do you understand the meaning of monetary policy?

Yes ☐ No ☐ Somehow ☐

04. Do you like your countries monetary policy?

No ☐ Yes ☐ motivate bank activities ☐

05. Why you don't like the policy?

I don't know ☐ Very poor ☐ Poor ☐

06. Why do you like the policy?

Good ☐ Best ☐ Challenging ☐

07. Does the exchange rate fluctuation favor your bank?

No ☐ Yes ☐ I don't know ☐

APPENDIX 2

Curriculum Vitae

Personal Information:

Surname	:	Mkumbwa
Given Name	:	Mathew Ernest
Address	:	P.O. BOX 1526
	:	Dodoma
	:	Tanzania
	:	Tel. No. 0007262354175
	:	Cell. No. (0007755554426, +254712205951
E-mail	:	mathewmkumbwa@yahoo.com
Date of Birth	:	November, 9th , 1983
Place of Birth	:	Dodoma Municipal
Nationality	:	Tanzanian
Present Resident	:	Tanzania
Martial Status	:	Single

Objective:

To be able to acquire every bit of knowledge for the benefit of the society and the Nation so as to serve with
Motivational and supporting the team to achieve higher standards of performance.

Education

Level	Award	Year
Primary school	Certificate of primary education	*1991 – 1998*
Ordinary level	Ordinary certificate of secondary education	*1998 – 2002*
High School	Advanced certificate secondary education	*2003 – 2005*
University (Undergraduate)	Bachelor of international business administration	*2006 – 2009*

Language skills	:	English language
	:	Basic French
	:	Kiswahili language
Special Awards	:	Academic awards
	:	Discipline certificate
	:	Leadership certificates

Vocational Experience:

2003 2005 : General secretary Tanzanian students Christian Fellowship (TSCF)
2008 : Peace building delegate from Tanzania at Amouhoro Africa, Rwanda.
May 2008 : Electoral commissioner as Security officer – Kampala International University
July 2008 : Trade bazaar organizer Kampala International University
May 2009 : International business academic exhibitor at Kampala International University
Jan–Feb 2009 : Documentation clerk at the clearing and forwarding company Tanga port – Tanzania

Key Skills

Leadership background, motivation, and organization.

Memberships

Vice chairman Federation of Ugandan Employees – Kampala international University branch

Interests

Reading books, Listening Music and playing basketball

Referees

Mr. Paul Mwanga
Public information officer

Abraham Mkumbwa

Liaison officer - Mabita Company Ltd

APPENDIX 3a

Map of Tanzania

APPENDIX 3b

Map of Tanga region

APPENDIX 4a

Time frame

TIME FRAME FOR THE RESEARCH REPORT	
Duration	**Activity**
1^{st} Jan – Feb 20^{th} 09	Collection of data
20^{th} Feb – 30april 09	Preparation of data
20^{th} May – 20^{th} June 09	Proposal writing
23^{rd} Jun – 25 June 09	Data editing and coding
26^{th} June – 30 June	Data analysis and presentation
30^{th} June – 6^{th} July	Report writing

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OFFICE OF THE DEAN
SCHOOL OF BUSINESS AND MANAGEMENT

Date: 20th May, 2009

Our Ref: KIU/SBM/RL/002-05/09-6

THE HUMAN RESOURCE MANAGER,
CRDB - TANGA

Dear Sir/Madam,

RE: MATHEW ERNEST MKUMBWA REG.NO.BBA/19271/72/DF

The above mentioned is a bonafide student of Kampala International University pursuing a Bachelor of International Business Administration in the School of Business and Management of the University.

He is currently conducting field research and the title of the Research project is "AN ANLYSIS OF THE EFFECT OF MONETARY POLICY to the DEVELOPMENT OF COMMERCIAL BANKS IN TANZANIA. As part of his studies (research work) he has to collect relevant information through questionnaires, interviews and other relevant reading materials.

The purpose of this letter is to please request you to avail him with the necessary information he may need.

All and any information shared with him will be used for academic purposes only and we promise to share our findings with your institution.

Any assistance rendered to him in this regard will be highly appreciated.

Yours Sincerely,

KAMPALA INTERNATIONAL UNIVERSITY
BUSINESS & MANAGEMENT STUDIES
BOX 20000, KAMPALA

DR. ALFRED NUWAGABA
DEAN SCHOOL OF BUSINESS AND MANAGEMENT