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Beating the addiction to dollars: Policy options for Tanzania

“The use of the US dollar as a unit of account, medium of exchange and store of value in Tanzania has raised concerns among policymakers and the general public.

The percentage share of Tanzania’s bank deposits that are denominated in US dollars is higher than that of Kenya, which has the biggest economy and most developed financial sector in the region. Also, absolute dollar deposits in Tanzanian banking sector are on average equal to those of Kenya and well above those of the other countries in the region.

This may partly be a reflection of the extensive economic reforms implemented since early 1990s, which transformed Tanzania from a centrally planned to a market-oriented economy. In this case,the increase in dollar inflows to the economy may just be a natural phenomenon resulting from the fact that the Tanzanian economy has become much more open and outward-oriented than it was some 20 years ago.

Increased confidence in the financial sector and the economic situation in general may partly explain the large share of foreign currency deposits in the financial system, as foreign currency held by residents in offshore banks finds its way back following the removal of foreign exchange controls in 1992. Also, since the 1990s Tanzania has attracted more foreign direct investment (FDI) than other countries in the region. FDI flows to Tanzania increased rapidly following the economic reforms to a peak of about 6% of GDP in 1999, before declining gradually to the current levels of about 4% of GDP.

During the same period,Tanzania’s export growth has also accelerated significantly. In addition, total aid flows to Tanzania as measured by the total net official development assistance (ODA) has increased from about 10.5% of GDP in the second half of the 1990s to an average of around 12.5% for the period 2000-08. The counterpart to this relatively high aid share in GDP is the presence on the ground of a large number of aid agencies and international NGOs, most of which tend to conduct their business substantially in foreign currency.

On the other hand, unlike other countries in the region, there are substantial restrictions in Tanzania’s capital account, with all types of capital outflows (FDI and portfolio) essentially prohibited. Such restrictions, to a large extent, limit residents from investing their wealth abroad, in which case, foreign currency deposits becomes the second-best form of inflation-hedging investment. The significant inflows of foreign currency in the economy accompanied by restricted outflows may partly explain the apparent higher levels of dollarisation in the Tanzanian banking sector.

It is however, worth noting that although Tanzania appears to be the most dollarised economy in the region, its dollarisation ratios are moderate by international standards. For example, according to Bolino et al. (1999) an economy is considered to be highly dollarised if the ratio of foreign currency deposits to broad money exceeds 30%. Many countries in Africa – including Zambia, Angola, Liberia and Mozambique – have ratios in excess of 30%. In Tanzania this ratio is currently about 25%. Also the use of foreign currency in carrying out transactions is so far limited to housing and apartment rentals, sales of plots in some parts of major cities, fees for some private schools and a few imported durable consumer goods such as laptops.

However, I share the views of those who believe that if left unchecked, the extent of dollarisation in the country could potentially explode to levels that will be difficult or costly to reverse. Evidence from countries like Cambodia, Vietnam and Israel suggest that once an economy becomes highly dollarised, the process of de-dollarisation may be very costly and protracted. As Reinhart et al. (2003) noted, economies remain 'addicted to dollars' even after the disappearance of the factors that initially led to the dollarisation phenomenon.

There are several policy measures that may warrant consideration by the Tanzanian authorities:

- Encourage banks to extend foreign exchange denominated loans mostly to the tradable sector. For the non-tradable sector, banks could be asked to require foreign currency borrowers to actively hedge their loans against exchange rate risk – for instance by buying forward. Alternatively, commercial banks could implement a more rigid set of collateral requirement on foreign currency denominated loans to their non-exporting borrowers.
- Ensure that commercial banks are keeping adequate levels of foreign currency liquid assets (in cash or reserves) in order to serve as a buffer in the event of a bank run.
- Ensure that long-term macroeconomic stability is maintained. There is substantial evidence suggesting that dollarisation in general is driven by a desire by firms and households to hedge against inflation and exchange rate risks.
- Financial and banking sector reforms to develop a vibrant financial market with an increased range of investment outlets in the form of local currency denominated interest-bearing assets. Such a move could provide alternative investment opportunities to foreign currency deposits.
- Limit the use of foreign currency as a medium of exchange for goods and services in the domestic economy; for example, by increasing the denomination of Tanzanian banknotes. The largest denomination of Tanzanian shilling is currently the equivalent of about US$7.5, which is the smallest in the EAC region and may make the currency less attractive for carrying large ticket transactions. A more direct intervention would be for the authorities to impose a regulation that requires that only Tanzanian shilling be used as a medium of exchange in domestic

Tanzanian shilling be used as a medium of exchange in domestic transactions.

I would advise against seeking to reduce financial dollarisation through any direct measures because international evidence suggests that enforcing de-dollarisation can be counter-productive; Galindo and Leiderman (2005) present evidence of unsuccessful forced de-dollarisation in some Latin American countries. Countries where de-dollarisation has been gradual and market-driven have had some success. Galindo and Leiderman identify three countries (Chile, Israel and Poland) that have been able to de-dollarise their financial systems successfully through market-oriented measures and better macroeconomic management.

Further reading

Bolino, T, A Bennett and E Borensztein (1999).“Monetary Policy in Dollarized Economies”, IMF Occasional Paper n. 171

Galindo, A and L Leiderman (2005), “Living with dollarization and the route to dedollarization”, IADB Research Department Working Paper # 526.

Kessy, P (2011), “Dollarization in Tanzania: Empirical Evidence and Cross-Country Experience”, IGC Working Paper No. 11/0251.

Reinhart, C M, K Rogoff and A M Savastano, (2003), “Debt Intolerance”,Brookings Papers on Economic Activity 1 (Spring), pp. 1–74.

– See more at: http://www.ideasforafrica.net/articles/beating-addiction-dollars-policy-options-tanzania#sthash.2iV43LDj.dpuf”