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## Financial sector liberalization in developing countries

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# FINANCIAL SECTOR LIBERALIZATION IN DEVELOPING COUNTRIES



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Mr. Chibuiké Uché, professor of Banking and Financial Institute, University of Nigeria wrote this paper. He is entirely responsible for the views expressed in the paper. The review of literature on experience of banking sector reforms undertaken by many developing and least developed countries will contribute to building stakeholder confidence in their governments' efforts to reform their banking sector.



## Contents

Acknowledgement.....	i
Introduction.....	1
Origins of Financial Liberalization .....	3
Financial Liberalization in Developing Countries: A Critique .....	8
Conclusions and Recommendations .....	15
References.....	16

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## Introduction

Arguably the most contentious topic in international finance is the issue of financial liberalization. This has been defined to include the adoption of the following policies: market-determined interest rates; greater ease of entry into the banking sector to encourage competition; the elimination of directed credit programmes; reduced fiscal dependence of the state on credit from the banking system (to allow for greater expansion of credit to the private sector); the integration of formal and informal markets, and; a movement towards equilibrium exchange rates and eventually flexible exchange rate regimes with open capital accounts<sup>1</sup>. This issue has divided researchers and experts across countries. Even within the International Monetary Fund, an institution widely criticized for promoting financial sector liberalization, there are divisions. Along these lines, it has been asserted thus:

*Few issues have attracted as much controversy as the removal of controls on international capital flows—a process known as capital account liberalization. The International Monetary Fund has been at the centre of this controversy. The formal rules of the IMF provide member states with the right to use capital controls, and these rules have not changed significantly since the organization was founded in 1945. But informally, among many staff within the Fund in the 1980s and 1990s, capital controls, once part of economic orthodoxy, became identified as an economic heresy. Although liberalization was not encouraged indiscriminately, the belief that the free movement of capital was desirable—what I call the norm of capital freedom—became the new orthodoxy<sup>2</sup>.*

In recent times, this issue has again been brought to the fore especially in the context of developing countries, which are arguably believed to have borne the brunt of such policies<sup>3</sup>. The adoption of financial liberalization policies by many developing countries, for instance, has led to banking sector instability and fragility<sup>4</sup>. Along these lines, it has been noted thus:

*Over the course of the last fifteen years, Mexico, Thailand, Malaysia, South Korea, Indonesia, Russia, Turkey and Argentina have all been struck by financial crises. Two remarkable characteristics of this recent phenomenon include the “developing” status of the affected countries and the fact that their respective crises have tended to coincide with financial liberalization measures. Such reforms allowed international investors seeking high returns the freedom to invest in high risk developing economies<sup>5</sup>.*

Based on the above, it is clear that most developing countries that went through the agonizing financial liberalization reform process have been unable to enjoy the promised benefits in general, and

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<sup>1</sup> See Serieux (2008, p.5). See also Hubler et al (2008, p.395-6) and Reinhart and Tokadlidis (2000, p.5). For our purposes therefore, financial sector liberalization will include capital account liberalization. It has been explained that “in a fully liberalized capital account regime, banks and corporations are allowed to borrow abroad fully. They may need to inform the authorities but permission is granted almost automatically. Reserve requirements might be in place but are lower than 10 percent. Also, there are no special exchange rates for either the current account or the capital account transactions; nor are there any restrictions to capital outflows” (Arestis and Caner, 2004, p. 2).

<sup>2</sup> Chwieroth (2010, p.1).

<sup>3</sup> The usual practice in such jurisdictions is to use the banking sector as a proxy for the entire financial system. This is so because in such jurisdictions, the banking industry has always dominated the financial system. It has for instance been asserted that: “A key stylised fact about financial systems in developing countries is that they are dominated by commercial banks.... Assets of insurance and pension companies are minuscule in most developing countries. Development financial institutions such as agricultural and development banks are also small compared with the commercial banks. Commercial bond markets are typically thin and government bond markets are often used only by captive buyers obliged to hold such bonds to satisfy liquidity ratio requirements or to bid for government contracts. Although equity markets are sizeable in several developing countries, their role in the process of financial intermediation between the household and business sectors remains small” (Fry, 1997, p.754).

<sup>4</sup> See Demirguc-Kunt and Detragiache, 1998, p.5.

<sup>5</sup> Charette (Undated, pp.1-2).



the promised financial sector prosperity in particular<sup>6</sup>. Although financial liberalization can contribute to economic development, the openness of financial markets in developing countries that adopt this policy also makes such countries more vulnerable to financial disruptions<sup>7</sup>.

It is in the light of the above that there is need to rethink the entire concept of financial liberalization and its applicability to developing countries. In order to achieve the above objective, this paper is divided into three parts. Part One critiques the origins and structure of financial liberalization and documents the various concerns of developing countries about financial liberalization. Part Two critiques the above concerns in the context of the specificities and experiences of the developing countries while Part Three concludes the paper.

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<sup>6</sup> Geda, 2006, p.4.

<sup>7</sup> Ito, 2006, p.303.

## Origins of Financial Liberalization

Historically, the conventional wisdom in finance was that financial sector liberalization was unsuitable for developing countries. This point was perhaps best made by Gashenkron in his description of industrialization in 19<sup>th</sup> Century Russia. According to him:

*The scarcity of capital in Russia was such that no banking system could conceivably succeed in attracting sufficient funds to finance large scale industrialization; the standards of honesty in business were so disastrously low, the general distrust of the public so great that no bank could have hoped to attract even such small capital funds as were available, and no bank could have successfully engaged in long term credit policies in an economy where fraudulent bankruptcy had been almost elevated to the rank of a general business practice. Supply of capital for the needs of industrialization required the compulsory machinery of the government, which, through its taxation policies, succeeded in directing incomes from consumption to investments. There is no doubt that the Government as an ogens movens of industrialization discharged its role in a far less that efficient manner. Incompetence and corruption of bureaucracy were great. The amount of waste that accompanied the process was formidable. But when all is said and done, the great success of the policies pursued... were undeniable<sup>8</sup>.*

Despite the numerous backward and administrative negatives in such backward countries, state intervention remained arguably the most viable option for the promotion of economic development in backward countries. The notion that liberalization of the financial system was sufficient to tackle the structural deficiencies of such economies was therefore unviable at the time. Furthermore, Gershenkron did not consider the financial system as the most important ingredient in promoting economic development in backward countries. According to him, a disciplined and well trained labour force was the most important factor in this process<sup>9</sup>. The issue of financial liberalization was therefore secondary.

Gershenkron's work however described a period when most of the developed economies had internal opportunities for the investment of capital and profits. International capital flows was therefore not an issue. Around the period therefore, the major academic debate in this direction was on the relationship between financial development and economic growth<sup>10</sup>. The above debates led to calls for more empirical and theoretical research on the subject matter. Along these lines, it was, in 1966 asserted thus:

*An observed characteristic of the process of economic development over time, in a market oriented economy, using the price mechanism to allocate resources, is an increase in the number and variety of financial institutions and a substantial rise in the proportion not only of money but also of the total of all financial assets relative to GDP and to tangible wealth.... However the causal nature of this relationship between financial development and economic growth has not been fully explored either theoretically or empirically<sup>11</sup>.*

All these however changed in the 1970s with the emergence of petrodollars mainly from the Gulf States looking for investment outlets. This was as a result of the quadrupling of oil prices in the early 1970s. The consequence of the above was that several western banks were awash with petrodollars. Ironically, the same oil price hikes which led to the emergence of the petrodollars also triggered a

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<sup>8</sup> Gershenkron (1962, pp. 19-20).

<sup>9</sup> "But the overriding fact to consider is that industrial labor in the sense of a stable, reliable, and disciplined group that has cut the umbilical cord connecting it with the land and has become suitable for utilization in factories is not abundant but extremely scarce in a backward country. Creation of an industrial labor force that really deserves its name is a more difficult and protracted process" (Gershenkron, 1962, p.9).

<sup>10</sup> Arestis (2003, pp. 2-3).

<sup>11</sup> Patrick (1966, p.174).

recession in some parts of the West. The consequence of this was that several Western banks began to look for investment opportunities for their petrodollars in the developing world. It is for instance now well established that these petrodollars were at the roots of the Latin American debt crisis in the 1980s<sup>12</sup>. A less well known consequence of the emergence of petrodollars is the fact that it led to pressures for developing countries to adopt financial liberalization policies. This no doubt was to help create investment opportunities for idle petrodollars in Western banks in these developing countries.

It was perhaps no coincidence that the theoretical arguments for financial sector liberalization were developed at about the same time. Specifically, it was at this stage that the issue of financial liberalization, which is an exposition of the theory which suggests that financial development drives economic growth, became prominent. Excess capital in the mainly mature economies of developed countries needed investment outlets in less developed countries. Liberalizing the international financial system to allow for free capital and financial flows therefore suited the agenda of western banks and western governments at the time<sup>13</sup>.

The two most important studies that advanced the above argument were developed independently in 1973 by Ronald McKinnon and Edward Shaw. Their views have come to be known as the McKinnon-Shaw hypothesis of Financial Liberalization. The foundation of this theory is the belief that the formal financial systems of developing countries are generally repressed with the consequence that the majority of its citizens and businesses are forced to seek financial assistance from outside the formal banking sector. This has been explained thus:

*Organized banking has a sorry record in penetrating the hinterland of less developed countries (LDCs), in serving rural areas in general, and in serving small borrowers in particular. Bank credit remains a financial appendage of certain enclaves: exclusively licensed import activities, specialized large scale mineral exports, highly protected manufacturing, large international corporations, and various government agencies, such as coffee marketing boards or publicly controlled utilities. Even ordinary government deficits on current accounts frequently preempt the limited lending resources of the deposit banks. Financing of the rest of the economy must be met from the meager resources of money lenders, pawnbrokers and cooperatives. It is this phenomenon that I call "financial repression"<sup>14</sup>.*

Financial repression has been popular in developing countries for three main reasons. First, there is a natural instinct in such countries to prohibit usury. Arguably the best known proponent of this view is Maynard Keynes who argued that interest rates are not self adjusting at a level best suited for the social advantage but constantly tends to rise too high. It is therefore necessary for governments to curb it by statute or custom<sup>15</sup>. The problem with the above view however is that it tends to avoid tackling the real reasons behind interest rate hikes which is normally inflation. Under such scenarios, credit ceilings which naturally lead to credit rationing simply create arbitrage opportunities for the financial institutions operatives allocating the credit to make private profits. The fact that the entire informal sector and most small businesses in developing countries extensively rely on informal credits

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<sup>12</sup> "The debts were contracted in the 1970s when Northern banks were flush with petrodollars. These flowed mainly from countries in the Middle East whose coffers were bulging as a consequence of a fourfold hike in oil prices. Naturally, commercial banks sought every opportunity to invest the money and, in the process, make a hefty profit. The investment climate was not bright in northern countries, especially Europe, as increased energy costs had triggered a recession. Undeterred the First World banks looked South to the Third World as a favourable location for their investment. Governments in the Third World, urged on by Northern consultants from institutions like the World Bank, judged it a favourable time to borrow. Interest rates were low. Borrowing cheap money seemed to be an eminently reasonable way of undertaking much needed development. Unfortunately things went badly wrong. In the early 1980s the foreign debts mushroomed out of control" (Columban Missionaries, 2010).

<sup>13</sup> More recently, it has been suggested that: "In reality, the move towards financial liberalisation has been prompted by the private financial institutions (such as investment and commercial banks, mutual funds, hedge funds). They have campaigned for the removal of national barriers so that they can shift their huge funds from country to country to obtain the maximum profits from speculating or investing in currencies and shares and to earn higher returns for providing loans. At present the equivalent of two trillion American dollars is shifted across borders EVERY DAY. Almost all of this (98 percent) is not related to trade or direct long-term investment, but comprises short-term capital funds" (Khor, 1998).

<sup>14</sup> McKinnon, 1973, pp.68-9.

<sup>15</sup> Quoted in Shaw, 1973, p.92.

which are normally obtained at sometimes very high interest rates clearly show that financial repression has in no way improved the credit costs of the majority of citizens and businesses in developing countries.

A second reason for the popularity of financial repression in backward countries is the general belief that such countries do not have the discipline to control their nominal money. This makes it impossible for financial deepening to take place in such economies. Along these lines, it has been asserted thus:

Real financial growth or deepening does not occur unless nominal money is under effective constraint or unless inflationary effects of monetary indiscipline are compensated by changes in relative prices including especially interest rates and foreign exchange rates. Uncompensated expansion of nominal money, we know, is a tax on real balances, and rational holders of financial assets evade the tax by shifting to forms of wealth that are less vulnerable<sup>16</sup>.

While the above assertion is no doubt correct, financial repression may not be the best option in engendering economic development in such backward territories<sup>17</sup>. It had little success in the many developing countries where it had been widely practiced. Perhaps more important is the fact that the indiscipline that makes backward states unable to control their money supply is a major impediment to economic development itself.

The third reason for the popularity of financial repression in developing countries is the widespread belief that financial deepening is an ineffective developmental strategy because it is expensive in terms of scarce factors of production. Specifically it is argued that backward countries do not have the requisite skills or regulatory structures to police such liberalized financial systems. Furthermore, another argument in support of the point is the intuitive view that market forces do not work in backward countries. Although this may be true, the reality is that financial repression plays a major role in distorting market forces in such economies. Perhaps more troubling is the fact that perverse financial repression in backward countries has been unable to contain the expansion of the informal credit markets which is the major life line of informal and small businesses. It has also been unable to fuel economic development in several of such countries<sup>18</sup>.

Based on the above, it is not surprising that the theory of financial liberalization is based on the belief that the informal financial system, which is perverse in developing countries are less efficient than banks in undertaking the intermediation function. By removing credit ceilings, which is usually a dominant characteristic of financial repression, and allowing market forces to determine interest rates, banks are better able to attract deposits from the unproductive cash holdings, less productive self investments and inflation hedges to the official banking sector which will intermediate these funds to the more productive industrial sector.

Not all scholars however agree with the above view. Scholars of the neo structuralism mode for instance, argue that the official banking sector is less efficient than the financial markets outside (informal financial sector), which operates in a liberalized fashion, in intermediating financial resources. The above view is based on the assumption that the informal credit market provides

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<sup>16</sup> Please note that although growth in nominal money may be essential for economic progress, it is not the only condition necessary. In fact, such growth, if excessive, could inhibit economic development by reducing real money and sacrificing the income, savings, investments, employment and distribution effects of real money. See Shaw (1973, pp.95 and 102).

<sup>17</sup> The consequences of financial repression include: administered low nominal interest rates often resulting in negative real rates; small and oligopolistic financial sectors relative to the size of the economy dominated by intermediation in short term financial assets; dual economies with capital intensive modern sectors served by cheap foreign exchange and low interest finance and labour intensive traditional sectors left to be served by informal finance; large government deficits; and low savings and investment rates and retarded economic growth (Serieux, 2008, p.3).

<sup>18</sup> Shaw, 1973, p.p.92-107.

complete intermediation while the formal banking sector does not because of stringent reserve requirements<sup>19</sup>.

Despite the above divergent views on the efficiency of the formal and informal financial sectors in the intermediation process, it has rightly been pointed out that there is no material difference in these two positions with respect to the core issue of liberalizing the financial system. Along these lines, it has been asserted thus:

*In essence, these seemingly opposing groups argue for the same objective: financial liberalization. They differ not on financial liberalization itself, but on the method of financial liberalization. That difference originates in their different perceptions of the efficiency of different financial submarkets in developing countries. So the real issue is not whether developing countries should liberalize the financial system. It is whether informal credit markets in developing countries are more efficient than the banking sector. This issue can be narrowed down to: (a) whether informal credit markets in developing countries really provide full intermediation or, at least, more intermediation than the banks; and (b) whether the allocation of funds through informal credit markets is as efficient as that through banks<sup>20</sup>.*

Financial liberalization is however more complex than liberalizing interest rates. As earlier mentioned, it also includes, liberalizing entry into the banking sector and capital account liberalization. Although international financial institutions and most developed countries fully support interest rate liberalization, as a total package however, there is no general agreement as to the utility value of such liberalizations in developing countries. Empirical studies on this subject matter have not been conclusive.<sup>21</sup> Despite the above, it is not surprising that western banks and governments have always pushed for financial sector liberalization in developing countries. This is because such liberalization facilitates the investments of western businesses in such emerging economies.

The IMF, although controlled by the developed countries of the West has however adopted a more cautious approach to especially capital account liberalization in developing countries. This has sometimes frustrated Western powers. Along these lines, it has been asserted thus:

*Capital account liberalization also remains an important concern of some governments. The European Union (EU) and the United States view liberalization as one of their top policy priorities; with Brussels pushing for it in the context of accession negotiations, and Washington insisting upon it in recent trade agreements with Chile, Singapore, and South Korea, as well as in its ongoing "strategic dialogue" with China. But the EU and U.S. positions have, on occasion, diverged from the IMF's approach, thus revealing important aspects of the political economy of the organization. For instance, in the context of Bulgaria's and Romania's accession negotiations, the IMF recommended the maintenance of selective controls, while EU officials opposed them. Similarly, the United States and the IMF have clashed over the need for China to liberalize its capital account. While the United States, in seeking to intensify pressure on the Chinese currency to appreciate, argues that China should liberalize more rapidly, some IMF staff members claim that China should slow down its liberalization until it strengthens its financial system and achieves greater exchange rate flexibility<sup>22</sup>.*

Exercising caution on the issue of capital account liberalization was no doubt the right thing to do. This is especially so given the fact that this issue is yet to be fully understood even within the IMF. This point has been explicitly conceded by the Managing Director of the IMF.<sup>23</sup> Despite this fact, capital

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<sup>19</sup> Cho, 1990, p.477.

<sup>20</sup> Cho, 1990, p.478.

<sup>21</sup> See, for instance, Kiyota et al (2007).

<sup>22</sup> Chwieroth (2010, p.10).

<sup>23</sup> "Financial globalization has both caused and been caused by the liberalization of the capital account. However, capital account liberalization has also brought macroeconomic and financial challenges that require careful management, including the

account liberalization policies were forced on several developing countries under the guise of structural adjustments in the 1980s and 1990s. This was arguably because such countries lacked both clout and skill in these negotiations process. It is also unlikely that such pressures for capital account liberalization in developing countries would abet in the near future. According to the Report of an International Conference on the subject matter:

*[f]or better or worse, the forces driving the movement towards greater capital account convertibility are not likely to diminish –barring a profound upheaval in the global economy- in the foreseeable future. The Mexican crisis of 1994, the Asian crisis of 1997-1998 and crises in Brazil and Russia has led many observers to question the stability of the global financial system, but none has resulted in any fundamental change in the underlying process. Instead.... The policy debate has increasingly centred around the institutional and macroeconomic frameworks that must be put in place to limit the exposure of developing countries to sudden capital flow reversals<sup>24</sup>.*

Other concerns of developing countries with respect to financial liberalization in general include the following:

- The belief that liberalization will lead to the neglect of small businesses and the informal sector in the credit allocation process.
- The belief that liberalization will be detrimental to domestic deposit mobilization especially in the rural areas.
- Financial liberalization would threaten the development of the local financial institutions given the fact that foreign banks have more capital, more experience and better reputations.
- The belief that foreign banks may serve as conduits for the outflow of capital through money or capital market transactions to the detriment of the capital account of a country.
- The belief that the local regulatory agencies are not well equipped to police the complexities of the operations of foreign banks<sup>25</sup>.

In the next section, we will examine the efficacy of the above concerns in the context of the experiences of developing countries with financial sector liberalization.

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orderly sequencing of liberalization with reforms in other areas, especially in the financial system. At times, these challenges have made for a disorderly process, as some controls are taken off and others are re-imposed to tackle various pressures. Yet there is no solid body of analysis on how best to proceed. This is a challenge to which the Fund must rise" (IMF, 2005, P.8).

<sup>24</sup> Schneider (2000, p. 3).

<sup>25</sup> Kiyota et al (2007, pp. 14-15).

## Financial Liberalization in Developing Countries: A Critique

Financial liberalization in several developing countries dates back to the colonial period. In most of the former colonies, foreign banks reigned supreme. In the entire British Africa, for instance, it was only in Nigeria that indigenous banks emerged during the colonial era. Even at that, such banks were small in terms of market size, when compared with the operations of foreign banks<sup>26</sup>. Their market also differed from those of the foreign banks. While for instance, foreign banks were established to service British colonial and commercial interests, indigenous banks mainly focused on the interests of Africans<sup>27</sup>.

Unfortunately, most of these indigenous banks were poorly capitalized, poorly staffed and poorly managed. The consequence of the above was that the colonial government was forced to introduce some basic regulations for banks in Nigeria. This led to the indigenous banking failures of 1952 and 1953. In fact, the few indigenous banks that survived did so because of Government support. This marked the beginning of government involvement in commercial banking in Nigeria<sup>28</sup>.

It was not until 1972 that the Nigerian Government decided to indigenize foreign banking operations in the country. The reason given for this was in order to help fund its wider interests in indigenizing several foreign businesses. By, 1976, the Federal Government had acquired controlling shares in all foreign banks in the country. This certainly did not augur well for the proper development of the financial system. Rather, it decimated the ability of these commercial banks, which are naturally allergic to inflation, to serve as a check on government fiscal indiscipline and their inflationary consequences. Government control of majority of the commercial banks therefore oiled financial repression.

It was however not until 1986 after the Nigerian economy began to show serious signs of weaknesses that the government under pressure from the IMF and the World Bank decided to introduce a Structural Adjustment Programme (SAP) and deregulate the Nigerian economy. Financial liberalization was central to this programme. For instance, the main strategies of the programme were: the adoption of a market determined exchange rate for the Naira, the deregulation of external trade and payments arrangements and reductions in price and administrative controls. A consequence of the above measures was the phenomenal increase in the number of financial institutions in operation in the country. The number of commercial and merchant banks, for instance rose from 41 in 1985 to 120 in 1993<sup>29</sup>.

Unfortunately, financial liberalization failed to achieve its anticipated benefits in Nigeria. Rather it led to financial fragility and financial system distress. In 1998 alone, for instance, 26 banking licenses were withdrawn by the Central Bank of Nigeria<sup>30</sup>. The reason for this has been explained thus:

*The pattern of liberalization in Nigeria's financial sector produced a chaotic speculative bubble, with disastrous consequences for the banking industry and the wider economy. Deregulation led to a tripling of banks over a five year period along with an explosion of unregulated non bank financial institutions. A large magnitude of scarce capital and professional talent flowed to the banking sector. Huge profits accumulated through foreign exchange and interest rate arbitrage, as well as through brazen fraud. The frenzy was aggravated by changes in the foreign exchange regime, erratic regulation, and precipitous fiscal and monetary expansion. Despite the introduction of a prudential framework along with other legal and organizational changes, the*

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<sup>26</sup> Uche (1997b and 2010b).

<sup>27</sup> See Uche (1997a, 1997) and Austin and Uche (2007).

<sup>28</sup> Uche (1997a; 1997b; and 2010b)

<sup>29</sup> See, for instance, Uche (1996, 1999 and 2001).

<sup>30</sup> Ogowewo and Uche, 2006, p.170.

*financial system completely overwhelmed the regulatory institutions deployed by the government*<sup>31</sup>.

It is however important to note that the Nigerian banking system was even after financial liberalization, still dominated by local banks. The failure of banking liberalization therefore had little to do with foreign banking operations and more to do with the inability of the Government to adhere to any form of fiscal discipline and provide a stable macroeconomic environment for such liberalizations to yield positive economic results. The above point was reiterated by a former Governor of the Central Bank of Nigeria who publicly complained thus:

*The greatest problem which has severely constrained the effectiveness of monetary and banking policies in Nigeria in the last few years has been the persistence of large government deficits and their mandatory financing by the CBN. The financing of government deficits by the CBN increases the monetary base and the level of excess liquidity of the banking system. A related problem in the mandatory role of the CBN is the underwriting of primary issues of government security thereby constraining the CBN's ability to regulate reserves*<sup>32</sup>.

The case for the majority of developing countries, several of which were former colonies of European countries was however not much different. Like Nigeria, the financial systems of several of such countries were historically dominated by foreign banks. Unlike Nigeria, most of these countries never nationalized foreign banking interests. Despite this, their various experiments with financial liberalization yielded mixed results. We shall critique the various reasons often cited by anti financial liberalization experts as the underlying factors behind the failure of financial liberalization in the context of developing countries.

#### **1. The belief that liberalization will lead to the neglect of small businesses and the informal sector in the credit allocation process.**

This is no doubt a very important concern that is rooted in the history of the development of the financial systems in several developing countries. It is for instance, a fact that historically, it was never the objective of foreign banks to facilitate the economic activities of former colonies. The consequence of this was that several of such countries, businesses, especially the small ones had to devise various informal and expensive mechanisms for obtaining credit. In Ceylon (Sri Lanka) for example, the Banking Commissioners in their report of 1934 concluded that:

*It was considered essential for the attainment of this goal of economic freedom that the public should have adequate financial assistance, so as to enable indigenous capital and enterprise to participate more actively in the trade and industries of the country and, in particular, to cultivate and expand the home markets in preference to the export markets. The prevailing banking system primarily designed to foster economic development by requisitioning the aid of non-indigenous capital and enterprise proved to be ill adapted, by the very nature of its structure, to offer such facilities*<sup>33</sup>.

In the case of Nigeria, the Government has long recognized the fact that it was difficult for formal bank credit to flow to small businesses and rural businesses and have responded with a plethora of regulations and schemes which have included: the rural banking scheme, Community banking scheme, sectoral allocation of credit directives, and establishment of a Peoples Bank directed solely at

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<sup>31</sup> Lewis and Stein, 1997, p.17.

<sup>32</sup> Ogwuma, 1993, p.156.

<sup>33</sup> Report of the Ceylon Banking Commission (1934, para 4).



small businesses<sup>34</sup>. A common characteristic of all the above schemes is that they all, without exception, failed to achieve their objectives.

The fear that liberalization will lead to the neglect of small businesses and the informal sector in the credit allocation process is therefore overstated. To properly gauge the risk, one must consider it in the context of the present reality. Even before liberalization, rural credit provided immense difficulties for formal financial institutions. Government intervention in this sector also failed. Dismissing liberalization and its positive benefits on the above grounds is therefore illogical. What will be useful if the credit needs of small businesses and rural businesses are to be met is for governments in developing countries to rethink their development strategies for these sectors. Poor infrastructural facilities like roads, electricity, portable water and security are the central causes of poor economic activities for small and rural businesses. Addressing these will no doubt change the dynamics of getting financial institutions to willingly extend credit to such businesses. Interestingly, the World Bank has argued that financial liberalization will benefit small businesses. This is so because the indigenous banks will find it difficult to compete with the big foreign banks. Given the above, they will have little choice but to specialize in small businesses. Although there is some sense in the above position, it is doubtful whether these local banks will succeed if the above structural problems are not addressed.

## **2. The belief that liberalization would be detrimental to domestic deposit mobilization especially in the rural area.**

This concern is also unfounded. From experience, it is clear that that liberalization has always led to increased competition in deposit mobilization by banks. In fact, rural deposits have increasingly become the target of formal banks in financially liberalized settings. In Nigeria, for instance, private banks have devised schemes of creaming off such savings through community banks/ microfinance banks<sup>35</sup>.

From the above, it is clear that financial liberalization has led to increased intermediation of rural savings. The major problem however with such arrangements is that rural savings end up being invested in urban areas. The Nigerian Government was no doubt very keen to prevent such a scenario. It's enabling laws for the rural banking scheme and community banking scheme, for instance, all had provisions for a sizeable portion of savings from localities to be utilized in such localities. These were always flouted by financial institutions mainly because the macro economic environment for rural and small business operations was very harsh. It therefore made economic sense for such local financial institutions to invest rural deposits in commercial banks which in turn invest these as loans to big businesses. In fact most of these micro finance institutions considered it financially prudent to pay the penalties for breaking government local investment rules rather than lend to local businesses operating under harsh infrastructural environment. Such problems would no doubt be less severe in developing countries with better rural infrastructure in place. In such jurisdictions, small businesses will no doubt have a better record of performance.

## **3. Financial liberalization would threaten the development of the local financial institutions given the fact that foreign banks have more capital, more experience and better reputations.**

The benefits and costs of foreign banking entry are well documented in the financial literature. Benefits of such entries include:

- By engendering competition, it increases the efficiency of the domestic banking sector;
- It improves the mechanism for credit allocation to the private sector. This is so because the evaluation and pricing of credit risks become more sophisticated;

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<sup>34</sup> See, for instance, Uche (1998, 1999 and 2007).

<sup>35</sup> See Uche (1998).

- It helps to build a domestic banking, supervisory and legal framework and foster overall transparency;
- Linkages of the foreign banks with the international markets and parent banks enables it to provide more stable sources of credit;
- foreign banks may reduce the costs associated with recapitalizing and restructuring in a post crisis periods

On the other hand, potential costs of such foreign bank entrance include:

- local banks may be forced to take more risks because of reduced franchise value
- Increased foreign bank presence may impair access to credit to some sectors of the economy.
- Because of their more advanced service and product delivery mechanisms, foreign banks cream off the most lucrative businesses from local banks.
- Foreign banks may increase financial instability by pulling out of host countries or by contagion from problems in home countries.
- The lending patterns of foreign banks tend to ignore local priorities because such banks have different focus<sup>36</sup>.

Theoretically, the above concern makes sense. It is for instance, well established in the literature that foreign banks have better skills, more capital, more experience and better reputations. Such banks are therefore likely to be more efficient and better managed than local banks. In the context of financial liberalization in several developing countries however, some of the above fears are overstated. This is in part because, historically, as has already been argued, several of such countries have been dominated by foreign banks. Financial liberalization can therefore provide no material additional risks to the possible concerns stated above.

Even in developing countries like Nigeria, Ethiopia and Tanzania which are all notable exceptions where local banks still dominate the financial systems, some of the above concerns still exist. As has already been stated, access to credit by small and rural businesses in Nigeria, for instance, has always been impeded. All the special programmes devised by the government to address the above problem failed. In Tanzania, the extensive Government control of the banking sector which was aimed at engendering economic growth and development have since failed. Along these lines, it has been asserted thus:

*In Tanzania, poor performance of the state-owned financial sector in late 1980s forced the government to search for new policy directions. NPLs were above 65 percent of the loan portfolio, fiscal and financial operations were not separated, and the appropriate regulatory framework was missing. In 1990, a special Presidential Commission recommended: (1) increased competition by encouraging entry of foreign banks; (ii) strengthening the existing financial institutions; (iii) developing management accountability; and (iv) Recovering NPLs. Based on these, the Government has issued a policy statement on financial sector reform with the aim of creating a market-based financial system, efficient in mobilizing and allocating resources and supporting long term economic growth<sup>37</sup>.*

Perhaps more important is the fact that it has been established that the major reason for indigenous banking distress in many developing countries is their poor governance structure which has allowed insider loans to proliferate. Along these lines, it has been asserted thus:

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<sup>36</sup> See, for instance, Bayraktar and Wang (2004, p.4). See also Cihak and Podpiera (2005, p.3) and Classens et al (2001, p.892).

<sup>37</sup> Cihak and Podpiera (2005, p.5).

*The single biggest contributor to the bad loans of many of the failed local banks was insider lending. ... Most of the larger local bank failures in Kenya, such as the Continental Bank, Trade Bank and Pan African Bank, involved extensive insider lending, often to politicians... Insider loans accounted for 65percent of the total loans of the four local banks liquidated in Nigeria in 1995, virtually all of which was unrecoverable.... Almost half of the loan portfolio of one of the Ugandan local banks taken over by the BOU in 1995 had been extended to its directors and employees<sup>38</sup>.*

The lesson from the above experiences is that local financial institutions do not grow simply because foreign financial institutions are stifled. Strengthening bank governance standards should be of more concern to regulators in such developing countries. Based on the above, it is not surprising that a 2001 study that investigated how foreign bank entry impacted upon domestic banking markets across 80 countries concluded that “in the long run, foreign bank entry may improve the functioning of national banking markets, with positive welfare implications for banking customers<sup>39</sup>”.

#### **4. The belief that foreign banks may serve as conduits for the outflow of capital through money or capital market transactions to the detriment of capital account of a country**

This is yet another unfounded belief. This is so for two main reasons. First, the financial systems of many developing countries are already dominated by foreign banks. Liberalizing the financial systems will therefore have little additional impact. The second related reason is the fact that many of these developing countries have consistently been net receivers of foreign capital. The African continent is no doubt the worst culprit in this regard. It has, for instance, been noted that since 1980, Africa has been the region with the weakest domestic resource mobilization record in the world. Based on the above, it is not surprising that more than 35 percent of the regions relatively low investment levels have been funded from foreign investments. It is also remarkable to note that the above foreign inflows have come largely in the form of official development assistance rather than private capital flows<sup>40</sup>.

Perhaps more important is the fact that it has been empirically established that capital flights in developing countries are not always caused by financial liberalization. In a 1998 study of nine African countries, for instance, it was concluded that:

African capital flight is determined by, among other things, low domestic deposit rates, high domestic inflation rates and expected overvaluation of the domestic currency. It is also found that there is a negative and significant relationship between capital flight and an increase in the domestic rate, suggesting that financial liberalization includes a reduction in capital flight in the nine sample African countries.... [Despite this] financial liberalization policies per se may not be the panacea for reducing capital flight Effective policy measures to reduce capital flight in the African context may need much deeper and more fundamental changes of the economic and political systems<sup>41</sup>.

From the above, it is clear that the concern that foreign banks may serve as conduits for the outflow of capital through, money or capital market transactions to the detriment of developing countries is misplaced. Capital flights in developing countries sometimes go beyond financial liberalization.

#### **5. The belief that the local regulatory agencies are not well equipped to police the complexities of the operations of foreign banks**

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<sup>38</sup> Brownbridge, 1998, p.16. See also Brownbridge (1998, p.179).

<sup>39</sup> Claessens et al, (2001, p. 908).

<sup>40</sup> Serieux (2008, p.1).

<sup>41</sup> Lensink et al (1998, p.1363-4).

Fears over the inability of regulatory agencies in developing countries to effectively regulate the activities of foreign banks are no doubt logical. It would for instance be unrealistic to expect regulatory agencies in many of such developing countries to have the necessary skills to regulate financial practices and products they know little about. Luckily for the majority of developing countries, the shallowness of their financial markets has thus far ensured that this loophole has not led to any major disaster. It would have been logical to at least hypothesize that the global financial crisis would have easily been transmitted to most developing countries through the activities of international banks. This has however not been so. This was because the sub prime financial securities that led to the global financial crisis were too complex for the relatively unsophisticated financial markets of several developing countries. What regulatory agencies in many of such developing countries should be more concerned about is the growing threat to their financial systems that is emerging from the inside of their various continents as a consequence of their regionalization.

Across all continents, regional integration bodies and free trade agreements are coming into place. The 1991 Treaty which established the African Economic Community, for instance, made explicit the direction of expected financial and economic integration and cooperation in the continent. Specifically, it stated thus:

*Member States shall, within a time-table to be determined by the Assembly, harmonize their monetary, financial and payments policies, in order to boost intra-community trade in goods and services, to further the attainment of objectives of the Community and to enhance monetary and financial co-operation among Member States... To this end, Member States shall: (a) Use their national currencies in the settlement of commercial and financial transactions in order to reduce the use of external currencies in such transactions; (b) Establish appropriate mechanisms for setting up multilateral payments systems; (c) Consult regularly among themselves on monetary and financial matters; (d) Promote the creation of national, regional and sub-regional money markets, through the co-ordinated establishment of stock exchanges and harmonising legal texts regulating existing stock exchanges with a view to making them more effective. (e) Cooperate in an effective manner in the fields of insurance and banking... Member States shall ensure the free movement of capital within the Community through the elimination of restrictions on the transfer of capital funds between Member States in accordance with a timetable to be determined by the Council<sup>42</sup>.*

Also, the African Union Charter states that "The Union shall have the following financial institutions whose rules and regulations shall be defined in protocols relating thereto:(a) The African Central Bank;(b) The African Monetary Fund;(c) The African Investment Bank<sup>43</sup>". Across the continent, various sub regional economic groupings are gradually being strengthened<sup>44</sup>. Despite the above, very little has been done with respect to the design and operationalisation of an effective continental financial system regulation structure for the region. Although technical meetings are ritually organised among bankers and central bankers from the various countries of the continent, no effective regional financial operations and regulatory framework has been developed.

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42 Articles 44 and 45

43 Article 19. Recently, Nigerian signed a Memorandum of Understanding with the African Union to host the proposed African Central bank. The Bank is expected to commence operations in 2021 (ThisDay, April 27, 2009).

44 "Current African integration arrangements can be divided into two broad groups: those that fit into the Lagos Plan of Action (LPA) adopted in April 1980, and those that were either in existence or came about outside the LPA ....The Lagos Plan was promoted by the ECA and launched in a special initiative by the OAU. It envisaged three regional arrangements aimed at the creation of separate but convergent and over-arching integration arrangements in three sub-Saharan sub-regions. West Africa would be served by the Economic Community of West African States (ECOWAS) which pre-dated the Lagos Plan. A Preferential Trade Area (PTA) was established in 1981 to cover the countries of East and Southern Africa, which was eventually replaced in 1993 by the Common Market for Eastern and Southern Africa (COMESA). For Central Africa the treaty of the Economic Community of Central African States (ECCAS) was approved in 1983.... Together with the Arab Maghreb Union (AMU) in North Africa, these arrangements were expected to lead to an all-African common market by the year 2025. The Lagos Plan was followed up in 1991 by the Abuja Treaty, re-affirming the commitment of the OAU's Heads of State to an integrated African economy.... In April 2001, African Heads of State launched the African Union at Sirte to replace the OAU" (Mathews, 2003, Chapter 6). See also Uche (2001b).

While the above status quo had not mattered in the past especially given the not very substantial economic and financial linkages between the various African countries, recent developments now call for a change in direction. Arguably the single most important factor that has promoted intra African capital movement was the establishment of the New Partnership for Africa's Development (NEPAD) in 2001. The NEPAD scheme was essentially championed by the business community in Africa's largest economy: South Africa, with the objective of using it as a spearhead to expand South African capital to other parts of the African continent. Given its origins, it is not surprising that NEPAD adopted a neo liberal economic approach that emphasises the supremacy of market forces in economic dealings within the continent<sup>45</sup>.

Partly as a result of the above development, South African banks have either been established or strengthened in several African countries. Absa Bank for example have subsidiary/ associated banks in Mozambique, Tanzania and Angola while Standard Bank has subsidiary/ associated banks in thirteen sub-Saharan African countries. First Rand Bank also has subsidiaries/ associated banks in Botswana, Swaziland and Mozambique. The bank has also been cleared by both the South African and Zambian regulatory authorities to establish a full fledged bank in Zambia.

Private Banks from Nigeria, which is the continent's most populous country, with no explicit strategic framework, have also been expanding their operations and capital to other parts of the African continent. This has no doubt been boosted by the recent consolidation exercise in the Nigerian banking sector. Access Bank, for instance, has subsidiaries in Cote D'Ivoire, Democratic Republic of Congo, Gambia, Rwanda, Sierra Leone and Zambia while Zenith Bank has subsidiaries in Sierra Leone and Ghana. The magnitude and speed of Nigerian banking investments abroad has made one commentator to enthusiastically assert thus:

*Nigerian banks have become major players in the global financial market with many of them establishing subsidiaries and branches outside the country. The race for Nigerian banks to establish subsidiaries and branches abroad is on. The banks are gradually breaking into foreign countries, especially in the Economic Community of West African States, ECOWAS, Southern and Central Africa, Europe and America. As at September 23, ten out of the 24 licensed commercial banks in Nigeria own at least a full-fledged licensed bank in a foreign country. These Nigerian banks are First Bank of Nigeria, FBN, Union Bank of Nigeria, UBN; Bank Intercontinental; Access Bank; Platinum Habbib Bank; Bank PHB and the United Bank for Africa, UBA. Others are Guaranty Trust Bank, GTB; Zenith Bank and Oceanic Bank. The last to make the list is FinBank, formerly First Inland Bank, which announced on September 22, presence in the Gambia through the acquisition of the Arab Gambian Islamic Bank<sup>46</sup>.*

A consequence of the above developments is the increasing financial linkages of the African countries. The stark implication of such cross border financial investments is that it is now becoming increasingly easier to transmit financial viruses from one developing country to another. There is thus an urgent need to develop a robust framework for the regulation of these multinational African financial institutions. This is even more critical given the wide variations in the economies of some of the various African countries.

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<sup>45</sup> See Ezeoha and Uche (2004).

<sup>46</sup> Newswatch Magazine, October 7, 2008.

## Conclusions and Recommendations

The essence of this paper has been to review the debate and practice of financial liberalization with special focus on developing countries. It shows how international developments have led to the promotion of financial sector liberalization by the International Monetary Fund and developed countries. These policies have been adopted by developing countries with sometimes disastrous consequences which have been due mainly to poor planning and sequencing. Despite its limitations, financial liberalization will aid the economic development of developing countries more than the failed practice of financial repression. The way forward therefore will be for developing countries to devise ways of curtailing the excesses of these liberalization measures. Arguably the most important need in this direction is for such countries to properly sequence their financial liberalization process. The first logical step in implementing financial liberalization policies would be for such economies to ensure macroeconomic stability by bringing inflation under control. This is the major explanatory variable between the divergent results of financial liberalization in Africa and Asia. This has been explained thus:

*Macroeconomic stability is a prerequisite for successful financial liberalization. In the generally successful Asian cases, macroeconomic imbalances were largely eliminated before financial reforms were introduced. Balance of payments and fiscal deficits were manageable, and inflation was relatively low. .. The situation is markedly different in Africa, where a number of countries have attempted to implement financial liberalization in an environment of ongoing inflation – largely a consequence of excessive fiscal deficits. In Ghana, inflation was more than 20 percent a year when interest rates were deregulated; in Zambia, inflation exceeded 100 percent at the time of reform. Attaining low but positive interest rates is difficult when inflation is high and volatile<sup>47</sup>.*

Aside from the above, there is also need for countries to develop strong institutions before embarking on financial liberalization. There is no doubt widespread agreement that financial liberalization is more likely to lead to banking crisis in countries with weak governance structures, high levels of corruption, ineffective contract enforcement mechanisms, inadequate prudential regulation and supervision of commercial banks and inefficient bureaucracies<sup>48</sup>.

A stable macroeconomic environment and the development of strong governance institutions are therefore essential prerequisites that should be put in place before developing countries begin to liberalize foreign participation in their domestic banking markets and deregulate interest rates. All developing countries however need to consider the issue of capital account liberalization very carefully. At the very least, it is widely accepted that this should be the very last phase of financial sector liberalization<sup>49</sup>. Theoretically, premature opening up of the capital account could undermine the liberalization process by giving rise to either inflation or appreciation of the home currency which may harm the export sector<sup>50</sup>. It could also expose the currencies of developing countries to all manner of speculative attacks. The financial crises in Thailand, Malaysia, Philippines and Indonesia in the 1990s, was at least in part caused by the speculative attacks on the currencies of these Asian countries. This was no doubt made possible by capital account liberalization<sup>51</sup>. The magnitude of the Asian financial

<sup>47</sup> Pill and Pradhan (1997, p.8). With respect to Africa, it has also further been noted that the problems of poor loans quality faced by the local banks were compounded by macroeconomic instability. Periods of high and very volatile inflation occurred in Kenya (46 percent), Nigeria (70 percent) and Uganda (230 percent) during the financial liberalisation period (Brownbridge, 1998, p.20). See also Ahmed and Suardi (2009, p.1625).

<sup>48</sup> Demircuc-Kunt and Detragiache (1998, p.6). See also Fry (1997, p.759).

<sup>49</sup> It is widely agreed that the sequencing should be as follows: (1) establishment of macroeconomic stability in order to get fiscal deficits under control (2) the development of financial markets and institutions to foster competition and (3) deregulation of interest rates and elimination of controls (Inanga and Ekpenyong (2003) and Bayraktar and Wang (2004, p.6).

<sup>50</sup> Seck and Nil (1993, p.1874).

<sup>51</sup> "With too many [Thai] baht chasing too few dollars, there was huge pressure for devaluation. The scent of panic attracted currency speculators... The Bank of Thailand initially dsought to defend the baht position by dumping its dollar reserves on the market, but by July 2, after loosing at least 9 million USD of its 39 billion dollar reserves, it had to throw in the towel. Speculators spotted similar skirtish behaviour among foreign investors in Manila, Kuala Lumpur, and Jakarta, where the same conjunction of commercial bank overexposure in real estate, weak export growth, and a widening current account deficit was stoking fears of a currency devaluation that could devastate their investments. By October 1 [of 1977], the Philippine Peso, the Malaysian Ringgit,

crises was no doubt enormous<sup>52</sup>. It is instructive that Asian countries like China and India which did not have significant capital account convertibility were relatively sheltered from the Asian financial crisis<sup>53</sup>. Since it is widely agreed that this phenomenon, which may be unstoppable, is yet to be fully understood, it would be prudent for developing countries, especially given their fragile economies, to approach it with great caution and trepidation.

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and the Indonesian rupiah were still on a downspin as capital continued to exit, resulting in a catastrophic combination of skyrocketing import bills, spiralling costs of servicing the foreign debt of the private sector, heightened interest rates spiking economic activity, and a chain of reaction of bankruptcies" (Charette, Undated, pp.11-12).

<sup>52</sup> "Since the second half of 1997, South East Asia has been gripped by an economic crisis from which there seems to be no relief. A year on from the outbreak of the crisis the economic indices made stark reading: the Indonesia rupiah had lost 82 per cent of its dollar value, the Thai baht about 42 percent, the Malaysian ringgit 38 percent and the Philippine peso more than 34 percent; in the same period, stock markets fell in dollar terms, by 89 percent in Indonesia, 73 percent in Malaysia, 71 percent in Thailand and 59 percent in the Philippines" (Bello, 1999, p.35).

<sup>53</sup> Khor (1998).

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