REPRESSED BANKING INDUSTRY: THE CONTEXT OF EMERGING MARKET

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How to cite this paper: Fekadu, G. W. (2020). Repressed banking industry: The context of emerging market. *Corporate Governance and Organizational Behavior Review, 4*(1), 54-60. http://doi.org/10.22495/cgobrv4i1p5

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ISSN Online: 2521-1889
ISSN Print: 2521-1870

Received: 18.02.2020
Accepted: 03.06.2020

JEL Classification: E02, E40, E44, E58
DOI: 10.22495/cgobrv4i1p5

Abstract

The present paper uses a qualitative approach with data obtained from secondary sources on the sequence and timing of financial liberalization in Ethiopia. The approach is purely qualitative, which simply examines the sequence of financial sector liberalization measures introduced in Ethiopia between 1992 and 2014. The study aims to identify the financial sector liberalization measures introduced and critically evaluate the timing and sequence of these programs implemented in Ethiopia. In light of documented empirical findings, it was found that the financial liberalization programme in Ethiopia was not properly and timely sequenced, and as a result, the Ethiopian financial sector has remained underdeveloped when compared to sub-Saharan African standards and its neighbouring countries. The regulatory fences, especially the restriction of foreign bank entry, should be seriously reconsidered and such fences shall be soon uprooted and steps towards the establishment of the financial market should be taken.

Keywords: Financial Liberalization, Foreign Banks Entry, Financial Sector, Ethiopia

Authors' individual contribution: The Author is responsible for all the contributions to the paper according to CRediT (Contributor Roles Taxonomy) standards.

Declaration of conflicting interests: The Author declares that there is no conflict of interest.

1. INTRODUCTION

With the replacement of the socialist government in May 1991, Ethiopia had claimed a new era of transformation in economic spheres. The economic transformation involved a radical change of the command economy into a market economy and private entrepreneurs and the operation of market forces are encouraged (Hanson, 2001). The new government launched a new economic policy that represented a radical departure from the past and emphasized to dismantle state intervention and to limit the role of the state in economic activity in favour of the expansion and deepening of the private sector. Since then, under the auspices of the structural adjustment program (SAP), measures focused on initiating and consolidating market-oriented economic policy, have been introduced including financial sector reforms (Ang, 2011).

The main objectives of the financial sector reform were to deregulate financial sector activities with a view to improve mobilization of domestic resources for investment and improve the efficiency of financial intermediation through greater reliance on market forces in resource allocation. In an attempt to achieve these objectives, the government has introduced a number of measures, the important being the enactment of Proclamation No. 84/1994 in January 1994 that allows the private sector to engage in the banking and insurance business.

Though Ethiopia has been opened its financial sector for domestic investors, it remains closed for the entry of foreign investors and the financial sector remains closed and less developed than many developing countries including its neighbours. Similarly, the Ethiopian banking sector, as it was in the past regime, continued to cut off from the influence of globalization and global financial crises and the country seems to had avoided both the big-bang and gradual reform theories of financial liberalization and attempts to get back to financial repression.

This study thus aims to identify the financial sector liberalization measures introduced and critically evaluate their sequence and timing of financial liberalization programmes implemented in Ethiopia. The paper is organized into six sections. The first section deals with the introduction. The theoretical and empirical literature is presented in Section 2. The third section is devoted to methodology. The sequence of financial liberalization programmes is presented in Section 4. Section 5 deals with critical analysis of the sequence and timing of financial liberalization in Ethiopia and the last section concludes the findings of the analysis followed by recommendations.

2. LITERATURE REVIEW

The outcomes of the financial repression that prevailed in developing and transition countries in the 1970s and 1980s had supported the views of two prominent liberal economists – McKinnon and Shaw, who believe that "financial repression" needs to end in emerging countries and advocate for financial liberalization. McKinnon-Shaw hypothesis states financial liberalization as "the process of breaking away from a state of financial repression". According to them, financial repression refers to the notion that a set of government regulations, laws, and other non-market restrictions, prevent the financial intermediaries of an economy from functioning at their full capacity and involves distortionary government interventions in the operation of financial markets, most conspicuously, through fixing interest rates, thereby, preventing interest rates from clearing the savings and investment markets (McKinnon-Shaw, 1973).

Bandiera (2000) defined financial liberalization as "an economic theory in favour of free competition and minimal government regulation" (p. 133). Montiel (1995) has elaborated financial liberalization as it includes a variety of measures, such as liberalizing interest rates, establishing freedom of entry in to, and procedures for an orderly exit from the banking industry, reducing reserves and liquidity requirements, eliminating credit allocation directives, eliminating preferential credit at concessional interest rates, and removing controls in the capital account of the balance of payments. From this definition, it is clear that liberalization does not mean a totally free and unregulated economic system as it claims some minimal degree of governmental regulation. The question to be resolved is when and how should the regulatory authorities be involved in a liberalized economic system.

Financial liberalization has been a major component of structural adjustment programs in developing countries and in the late 1980s and early 1990s, many countries of Latin America, Eastern Europe, Asia and Africa adopted a series of financial sector liberalization measures that include interest rate liberalization, entry deregulations, reduction of reserve requirements and removal of credit allocation (Chirwa, 2004).

The empirical literature on the impact of financial liberalization are by now abundant but with mixed and ambiguous results. The proper timing of financial reforms within the structural adjustment program and the appropriate sequence of financial reform policies have received more attention after the prescriptions of financial liberalization produced undesirable results in many emerging countries. Thus, the emerging literature not only set the pre-conditions of financial liberalization but also they have tried to put the chronological order of the liberalization in general and the financial sector in particular. The feasible sequence of financial liberalization within the structural adjustment program has been considered by many as a key for its success, that is inappropriate sequencing of financial reforms had an adverse effect on banks' health and may produce undesirable results.

There is a greater consensus for the need to precede financial sector reforms with stabilization measures in order to situate the reforms within a stable macroeconomic environment. Secondly, there is a need to restructure or liquidate defunct financial institutions and strengthen regulatory and supervisory activities before granting new licenses in an attempt to enhance competition in the system. According to Ikhide and Alawode (2001), these measures will help to improve asset quality, stimulate operating efficiency, and more importantly, they will prepare the banking system to withstand some of the shocks that may come with financial repairs.

Monteil (1995), who backs the importance of sequencing financial reform programmes, has suggested four-step financial liberalization sequence: restore macroeconomic balance, together with restructuring or liquidating ailing financial institutions; introduce indirect monetary instruments with freely determined interest rates, together with establishing the supervisory capacity of the central bank on the financial system; encourage competition in the banking sector, by encouraging more domestic and foreign banks and reducing government shareholding in the financial sector and liberalize interest rates and remove all forms of administrative controls on the financial sector.

In most countries, however, interest rate liberalization, which is recommended as the last step by many authors, came too soon, before other conditions were met and most countries have failed to follow this sequence of financial liberalization.

There is a greater consensus among the authors that there are four great sequences in the liberalization program. According to Edwards (1990), Krueger (1986), and McKinnon (1991), domestic financial liberalization must follow domestic real stabilization (sequence-1); domestic financial liberalization (sequence-2) should precede foreign trade liberalization (sequence-3), and capital account liberalization (sequence-4) should come as the ultimate of a sequence of total reform.

Supporting the views of the above authors, Chapple (1990), cited in Ikhide and Alawode (2001, p. 11) also dwelt on the timing of financial liberalization within an overall adjustment program. He outlined an economic liberalization framework with the following sequence: reducing the fiscal deficit, liberalizing the financial system, liberalizing

the trade account, and liberalizing the capital account. According to Chapple, financial liberalization can only be successful if implemented after monetary stability has been attained. In developing countries, fiscal deficits constitute the major source of monetary expansion and hence particular attention should be paid to achieving a significant reduction in the size of the public sector deficit prior to the introduction of financial liberalization program. He warned that liberalizing the interest rate without reduction of the public deficit would lead to explosive increases in both deposit and loan rates and, according to him, it is only after macroeconomic stability has been achieved and financial reform is well, that the trade and capital accounts can be liberalized, in that order. Dornbusch and Reynoso (1993) also underscored the importance of attaining macroeconomic stability prior to financial liberalization and further explained that high and unstable inflation often increases the demand for financial liberalization, but this might trigger further increases in inflation, especially if the deficits are large and the exchange rate is depreciating rapidly.

The direction of causality among the sequences might be controversial because there are two basic issues here. The first argument is that financial development is an essential element for economic growth and development and the second view is that economic development creates demands for particular types of financial services and the financial system simply responds to these demands. Recognizing this controversy The World Development Report affirms that there is no only one optimal way of commercial reform, and also the way depends largely on the economic conditions which characterize each country (World Bank, 1999). Empirically, the economic and financial condition of the individual countries, no doubt, have played a significant role in shaping the outcome of the reform process.

In general, there is a growing consensus among many authors and policymakers that the pattern, sequence, and timing of liberalization need to be determined in terms of each country's overall economic and financial progress. To realize the promised benefits of financial liberalization, the policymakers need to know the pre-conditions and the strategies and should decide when to start liberalizing each element of liberalization and how fast to move through it. To put it differently, to get the benefits outlined in the financial liberalization theory, the pre-conditions must be right, the timing of the reforms must be correct, sequencing of the reforms must be appropriate and the conduct of other macroeconomic policies must be consistent.

3. RESEARCH METHODOLOGY

The present paper uses a qualitative approach with qualitative data obtained from secondary sources to gather qualitative information on the sequence and timing of financial liberalization in Ethiopia. Secondary sources from the National Bank of Ethiopia (NBE) annual and quarterly reports, bulletins, magazines, and a series of directives issued by NBE have been used to gather the data. The approach is purely qualitative, which simply examines the sequence of financial sector liberalization measures introduced in Ethiopia between 1992 and 2014. The empirical literature on the pre-conditions, sequence, and timing of financial liberalization has been explored. The emphasis of this approach is to evaluate the sequence and timing of reform programmes in light of the reviewed literature and the pre-conditions undertaken by the Ethiopian government before embarking on financial liberalization. This approach is adopted to examine the financial liberalization measures which have been carried out in Ethiopia. Specifically, the study aims to explore the financial sector liberalization measures introduced in Ethiopia and critically evaluate the sequence of financial liberalization programme implemented in Ethiopia qualitatively.

4. ANALYSIS AND RESULTS

From the review of the empirical literature, it seems inconclusive to identify the right path of financial liberalization. Thus, the question "Is there a sequencing issue of financial liberalization and, if so, are these conditions met in Ethiopia?" will be explored and discussed hereunder. The major financial liberalization programmes introduced in Ethiopia from 1992 to 2014 have been presented in Table 1, below and the critical analysis of such sequencing and timing of financial liberalization programmes has been subsequently discussed.

Table 1. Sequencing, timing, and financial sector reforms in Ethiopia

Year	*Measures introduced*
1992	Foreign exchange rate devalued significantly
	Discriminating lending rates abolished
	Interest rates on banking loans and deposits were adjusted
	Directed credit to inefficient state enterprises was reduced significantly
	Discrimination between public and private undertakings was removed
1993	Fortnightly auction-based foreign exchange rate system introduced by NBE
1994	National bank empowered to regulate and supervise all financial institutions
	New Monetary and Banking Proclamation No. 83/1994 enacted, and bank licensing liberalized
	Licensing and Supervision of Banking Business Proclamation No. 84/1994 enacted
	Licensing & Supervision of Insurance Business Proclamation No. 86/1994 enacted
	Public banks were given greater autonomy and restructured
	Interest rates were revised
1995	Interest rates deregulated by setting the max. lending rates and min. deposit rate
	91-day monthly treasury bills auction system introduced
1996	Additional 28-day and 182-day treasury bills introduced
	Treasury bills auction increased from monthly to bi-weekly basis
	The minimum denomination of T-bills reduced to birr 50,000 from birr 100,000
	The fortnightly foreign exchange auction system changed into a weekly basis
	Licensing and Supervision of MFIs Proclamation No. 40/1996 enacted
	Issued directive to limit the type of investment banks may engage in
1997	Denomination of the treasury bills further reduced to birr 5000 from birr 50,000
	Lending rates fully liberalized and ceiling on lending rates abolished
1998	Wholesale inter-bank foreign exchange market was established
	Current account fully liberalized
	Forex for business, educational and medical expense and holiday travel liberalized
	Inter-bank money market established
1999	Issued directive to increase the minimum paid capital to 75 million birr from 50 million
	Financial Intelligence Center Regulation No. 171/2009 enacted
2001	Discount window facility introduced
	The minimum interest rate on deposits reduced to 3% from its previous 6%
	Paid-up capital required to establish a new bank raised from birr 75 million birr to 500 million
2002	Asset classification and provisioning directive re-issued by NBE
	Issued directive to limit single and related party borrower norms
2004	Non-resident Ethiopian allowed opening a foreign currency account
	Issued directive on credit information sharing norms for banks
2007	Minimum deposit interest rate raised from 3% to 4%
	Reserve and liquidity requirement raised to 10% and 20%
2008	Increased the reserve and liquidity requirement to 15% and 25%
	4th replacement asset classification and provisioning directive issued by NBE
2009	Prevention and Suppression of Money Laundering and the Financing of Terrorism Proclamation
2010	Banking, insurance, and MFIs risk management guideline
	The raised minimum interest rate on saving and time deposits to 5% from 4%
2011	National Payment System Proclamation No. 718/2011
	Issues 27% NBE bills purchase directive
2012	The Directive for Establishment and Operation of Credit Reference Bureau issued
	Issued directive to reduce reserve requirement *t* to 10% from 15%
2013	Capital goods financing companies minimum paid-up capital requirement directives
	Issued directive to raise the startup capital of MFI from birr 200,000 to birr 2 million
2014	Issued directive to lower liquidity requirement to 15% from 25%

Sources: Compiled by Author from NBE directives, annual and quarterly reports of various years.

As it can be seen from the aforementioned list of measures introduced with the Ethiopian financial sector since 1992, some of the measures are truly reform measures, while others could be considered as are stringent repressive measures. This analysis and discussion draw heavily on reviewed literature and the impact of such measures in Ethiopia, which serves as a useful backdrop for identifying the gap in the process of liberalization in the Ethiopian context.

No doubt, the Ethiopian financial sector has moved from a repressed era to a more liberal environment since 1992. Abolition of discriminatory lending rates and adjustment of both deposit and lending rates, reduction of directed credit to inefficient public enterprises, and equal treatment of private and public undertakings were encouraging reform measures towards a market economy.

The measures taken to strengthen and restructure the existing public banks before opening the sector for new private banks was the right approach from the sequential order of liberalization. The existing public banks, especially, Agricultural and Industrial Development Bank (AIDB) and Housing and Savings Bank (HSB) were in financial difficulty when liberalization commenced. Thus, there was a major capital restructuring of these banks before opening the market for private participation. This has enabled existing banks to widen their capital base and to improve asset quality, stimulate operating efficiency, and to prepare the existing financial institutions to withstand with the emerging competition.

After restructuring the existing public financial institutions and relatively empowering the national bank of Ethiopia, the Ethiopian government opened the financial sector for domestic private participation in 1994 and this was considered as a landmark in the Ethiopian financial sector as both the banking and insurance sector was deregulated to private domestic investment, while denying foreign entry.

The liberalization measures introduced, especially in the early stages of financial

liberalization, were welcoming strategies for the success of financial liberalization. Introduction of indirect monetary instruments, setting up of the foreign exchange auction procedures, liberalization of the current account convertibility, the introduction of the discount window facilities, partial deregulation of interest rates, establishment of the inter-bank money markets, issuing asset classification and provisioning norms and guidelines, and related measures taken to strengthen the regulatory environment of the financial sector, are the rightly timed and implemented steps in the process of financial liberalization. The gradual approach of financial liberalization followed until 2000 and measures taken were appropriate that needs to be appreciated and used as a role model for new liberalizers. Especially the denial of foreign entry in the early stages of reforms was the right sequential strategy that helped the country to deregulate the sector without facing instability.

In 1998, the National Bank of Ethiopia has fully liberalized lending rates while keeping the minimum deposit rate at 6 percent. From the point of view of the optimum sequence of liberalization, this was an early measure taken before allowing the financial sector for foreign bank entry into the domestic financial sector.

5. DISCUSSION

The puzzling question "How long does Ethiopia prohibit foreign entry?" remains unanswered. Despite heavy pressure from IMF, WB, and western countries including the United States Government, the Ethiopian Government continues by law to prohibit the entry of foreign banks and insurance companies to the country. Barriers to foreign entry in the banking sector reinforce inefficient state-owned enterprises by shielding them from the competition. The Ethiopian financial system is underdeveloped, and access to bank service is the lowest even in the SSA standard. A recent report by the World Economic Forum ranks the country's financial sector 120th out of 144 economies (World Bank, 2014).

The government's concern is that if a foreign entry were to be allowed to operate in Ethiopia, it may lose control over the economy. This position is based on the infant industry argument. It is understandable that a country should provide certain protection to its domestic financial sector at the initial stage of its development. After all, no country is born with a strong financial industry. However, the Ethiopian government should clearly chart out when and at which point the protection should be terminated. Almost seventeen years have been passed since such protection has been provided and domestic banks have not yet shown any noticeable advancement in their style of operation. They are now providing the same services with the same operational style that they used to give at the start of liberalization.

Prohibiting foreign bank entry at this time would prevent domestic banks from being weakened because of unfair competition from foreign banks. Greenspan (2001) described competition and the degree of openness of the economy and its integration with the rest of the world as one of the important and influential factors for growth and the existing empirical and theoretical literature have confirmed that the benefits that accrue from foreign entry by far outweigh the costs.

Contrary to the government's view, the potential benefits that can result from opening the sector for foreign direct investment remain substantial. First, foreign bank participation may have the potential for a positive impact on the efficiency of the Ethiopian banking sector. Competition demands that domestic banks continuously upgrade their skill and technology levels to stay in business. Secondly, the entry of foreign banks may improve bank regulation and supervision. According to Goldberg (2007), the entry of foreign banks in emerging markets, that are healthier than domestic banks, implicitly allows the introduction of stronger and more prudent regulation, increasing the soundness of the local banking sector. Third, the entry of foreign banks to Ethiopia will strengthen the financial sector and may have a positive impact on economic growth. Demirguc-Kunt, Levine, and Min (1998) and Mattoo, Rathindran, and Subramanian (2006) have found a positive correlation between financial sector openness and economic growth. Also, Beck et al. (2014), Levine, Loayza, and Beck (2000) and La Porta (2002), Lopez-Silanes and Shlefer (2002) concluded that an increase in bank concentration was an obstacle in obtaining financing for growth.

Banks in Ethiopia are unable to improve customer service, design flexible and customized products, and differentiate themselves in a market where product features are easily cloned. Ethiopian banking is unable to come from a long way of being sleepy to a high proactive and dynamic entity. Ethiopians have missed seeing the technological advancement in the banking sector which has been seen elsewhere in Africa and the world. The modern e-banking methods like ATMs, debit cards, credit cards, Telebanking, Internet banking, Mobile banking, and others are not much known in Ethiopia.

Money transfer as commercial banking service is allowed only in between branches of the same bank. However, from the public and the economy, there is a strong need for strengthening linkages among banks in order to allow a healthy flow of financial resources among financial institutions and optimize the contributions of the entire financial system to the development processes as a whole. Except Commercial Bank of Ethiopia, the rest of the banks have on the average less than 35 branches operating throughout the country and with such highly scattered branch network and disintegrated working system of banks it is hard to ensure efficient flow of financial resources and optimize the contributions of the entire financial system to the development processes.

The inefficiencies and lack of technological embracement could not have been seen so far, if the foreign banks had been allowed to operate in Ethiopia. One of the benefits that could have been gained from foreign bank entry was the diffusion of technical improvements and innovations in delivering financial services from the home country to the local banking sector. However, because of the denial of foreign bank entry into the Ethiopian financial sector, the domestic banks couldn't adopt and introduce new services into the banking system. It can be concluded that liberalization has not

brought any change in terms of technological transformation in the Ethiopian banking industry. Some of the banks, even today, do not have information websites which can help them to provide at least the information on financial services offered by them.

The potential for international financial institutions to wipe out the domestic base is very clear if Ethiopian banks do not begin thinking in the mindsets of integration and technological development. All banks in Ethiopia are too late to move with technological advancement and they should clearly chart out the time schedule for their integration and technological advancement as the government cannot rationally protect them forever and it is time to recognize this fact and act accordingly.

In general, the government's concern for foreign restriction seems understandable. However, there are compelling reasons that the Ethiopian government should recognize to pursue in liberalizing the domestic market for foreign participation. The empirical and theoretical literature reviewed indicates that foreign entry through financial liberalization improves bank supervision through regulatory spill-over and forces domestic banks to improve their efficiency and makes them competitive with foreign banks. Moreover, entry of foreign banks may also contribute to financial stability in the host country, and the total benefits of allowing foreign entry outweigh the costs.

Therefore, it is strongly recommended to open the Ethiopian financial sector to foreign entry and integrate with the global economy instead of closing the sector. The Ethiopian government should recognize the fact that the Central Bank, National Bank of Ethiopia, couldn't strengthen its regulatory and supervisory capacity and Commercial banks operating in Ethiopia (both public and private) couldn't introduce new financial service and technology in nearly two decades of the reform period. This is because commercial banks are currently comfortable with the highest profit they generate and they don't dare to invest in new technologies as their inefficient performance has been already given protection form the government.

The Ethiopian banking sector is a great example of how a high level of service is not always a necessity to generate huge profits. To bring a breakthrough in financial development and to bring the country to where it should be in the financial realm, it is time to clearly chart out the time frame and open the market for foreign entry and participation. Pursuing with such a policy restriction is just like imposing sanctions on its own people and economy. A gradual approach to foreign bank entry, like China, may be very important for Ethiopia to follow, but further research is recommendable.

6. CONCLUSION

Financial sector liberalization began in Ethiopia in October 1992, with the main objectives to deregulate the financial sector. In an attempt to achieve these objectives, the Ethiopian government has introduced a number of reform measures. However, those reform programs were not properly sequenced and timed in Ethiopia and, as a result, the Ethiopian financial system is the most underdeveloped even in East African standards.

The process of financial liberalization in its nature is an on-going endeavour. However, the approach adopted by the Ethiopian government in the process of financial liberalization is too sluggish and gradual, which does not meet the optimum sequence and timing of financial liberalization recommended in the reviewed literature. After all, no major reform measures have been taken place in the last decade, especially since 1998 and it seems that the on-going nature of financial liberalization has been disregarded in Ethiopia. No further, steps have been taken either to open up the domestic market for foreign entry or to establish the capital market, both of which are very crucial for the development of the financial system.

Opening of the domestic sector for foreign entry and establishment of the capital market should be issues of importance in Ethiopia, which should be reconsidered seriously. Therefore, the regulatory fences especially, restriction of foreign entry should be seriously reconsidered and such fences shall be soon uprooted and steps towards the establishment of the financial market should be taken.

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