Ilkogretim Online - Elementary Education Online, 2020; Vol 19 (Issue 4): pp.4294-4300
http://ilkogretim-online.org
doi: 10.17051/ilkonline.2020.04.764834

EFFECT OF REFORMS ON BANKING SECTOR IN THE CONTEXT OF INDIA

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ABSTRACT- In the aftermath of the severe balance of payments crisis of 1991, India embarked on a policy of economic reforms. Reform was a key plank of the finance market and the banking sector, which was the cornerstone of financial intermediation. The aim of the banking reforms was to encourage a diversified, stable and sustainable financial structure with the ultimate goal of increasing capital productivity through providing organizational stability, enhancing financial profitability and strengthening the institution. Since 1992, Indian banks have been increasingly open to domestic and foreign rivalry. India has a somewhat different path to financial reforms than many other nations. Whilst public sector banks were not privatized, many public sector banks were listed on bonds in a partial disinvestment mechanism and became subject in this manner to market discipline and greater disclosure. In addition, entrance and expansion of newly opened private sector banks and other international banks led to greater competitiveness. As a result, the share of public sector banks in overall commercial banking assets decreased steadily and there was a downward trend in Herfindahl's concentration index. In the post-reformation period, there was also a steady reduction in intermediation costs (defined as "the ratio of operations expenses to total assets") between bank classes (excluding foreign banks) and declines in nonperforming lending. The improvement of the banking system's efficiency has been reflected in many indicators. As a consequence of these reforms, the Indian banking sector has improved all-round competitiveness. While Indian banks showed the declination trend in post-reform business per employee of Indian banks to three times the cost-income ratio (i.e. the ratio of operational expenses to overall income lower interest expenses) and net interest margin (i.e. the over interest income scaled to overall bank assets) At the same period profits per employee is multiplied by about five, with a rise of about 17 percent. Concurrent changes have also been observed for the industry.

Keywords: Banking, Indian Banks, Economic reforms, Payment, Productivity

I. INTRODUCTION

Since 1991, radical transformations have been taking place in the Indian financial sector. Reforms also altered the corporate framework, ownership and domain of finance, financial and non-banking activities (NBFCs). The key thrust of financial sector reforms was the establishment of effective and healthy financial and business structures. Bank and non-banking reforms aim to create a deregulated climate, to improve prudential norms and supervisory systems, to change patterns of ownership and to increase competitiveness.

The Finance Committee was established in 1991 to propose the appropriate changes of the financial sector. This Committee was widely regarded as the Narasimha Committee. It was set up in 1991. As the main banks were nationalized on 19 July 1969, the Narasimha Committee evaluated and recognized the Indian banks' growth and development. The advances have unfortunately mainly been seen in the field of expansion and distribution of bank branches, creation of enormous jobs and mobilization of savings rather than improvement of production. Outdated technologies, in addition to corruption, bribery, illegal use of public funds, are found to be a significant downside to the banks' actual growth. Narasimham was named by the United Front Government as a committee to examine progress on banking reforms. On 23 April 1998, the committee presented its findings to the then Minister of Finance. A solid, reliable and profitable banking system of global quality was the key objective of the Banking Sector Reforms Committee.

The reforms have led to radical improvements in this vital segment of the economy in India. Banking sector performance has an effect throughout the economy. The main reforms of the banking sector include changing the policy structure; enhancing banks' financial soundness and credibility; developing a sustainable climate and strengthening the operational framework. Bank reform policies were introduced and sequenced by competition to allow banks to address external restrictions related to administered interest rate structural conditions, high levels of reserve pre-emption, and loan allocation in certain sectors.

Bank reform initiatives to increase production and productivity through competitiveness have been implemented. A summary of the effects of banking sector reforms in India was rendered in this paper.

II. INDIAN BANKING SECTOR

2.1 Brief History of Indian Banking Sector

The history of Indian banking can be divided into three main phases:

- **Phase I (1786- 1969) - Initial phase of banking in India**

The first banks, which began in 1786, were the General Bank of India, and the Bank of Hindustan, both now dead. The oldest bank in India, which started in June 1806 in Calcutta, is the State Bank of India. The Bank of Mumbai and the Bank of Madras were among three presidential accounts, the other two. Under charters of the British East India Company the presidency banks were established. In 1921, the three banks combined to create the Indian Imperial Bank. The presidency banks, like their successors, have been acting like central banks for several years. The Allahabad Bank, established in 1865, was the first entirely Indian bank. But there were almost no banks in India, in the current context of the word, at the end of the 18th century. For many decades to the start of the 20th century, the banking sector in India remained the exclusive domain of Europeans. In Calcutta in the 1860s too, foreign banks began to arrive. The Escompte de Paris Comptoire established a branch in Calcutta in 1860, while the Comptoired opened another one in Bombay in 1862. Calcutta was, mostly because of the business of the British Empire, India's most active trade port and was therefore turned into a banking centre. The Indian Reserve Bank assumed office in 1935 to regulate the Indian banking industry. The Reserve Bank was nationalized and granted wider powers on 1 January 1949 in accordance with the RBI Act of 1948 following India's independence. The State Bank of India (SBI) was India's first government sector bank before 1969. It was nationalized in 1955 under the SBI Act of 1955 during the first stage of the nationalisation of banks.

- **Phase II (1969- 1991) - Nationalization, regularization and growth**

In 1955, the Imperial Bank of India became the State Bank of India after India's independence. In 1969 the second wave of banking nationalization occurred. The then Prime Minister of India, Mrs. Indira Gandhi, nationalized fourteen banks this year. In 1980, six further banks with deposits of more than 200 crores were nationalized. The main aim behind nationalization was to spread banking network function in rural regions and to provide Indian farmers with cheap financing. Until the 1990s, the nationalized banks rose by some 4% closer to the Indian economy's overall growth rate.

- **Phase III (1991 onwards) - Liberalization and its aftermath**

Today, Indian banks have matured and their balance sheets are sound and clear. Increased retail credit demand, the rise in cards and debits, declining securitised NPAs, enhanced macroeconomic conditions, diversification, interest rates, regulatory reforms and policy modifications are the key growth factors (e.g. amendments to the Banking Regulation Act). In recent times, attention on technology has been given to such developments like increased competitiveness, product growth and brands, the strengthening of risk management processes. The Union Cabinet has recently agreed on 15-02-2017 to combine the State Bank of India to five of its affiliate banks, which will include State Bank of Bikaner and Jaipur, State Bank of Hyderabad, State Bank of Mysore, State Bank of Patiala, and State Bank of Travancore. Larger banks would have some of its relative advantages. The integration would result in a mix of increased operating performance and lower funding costs that are expected to save at over 1,000 crore Rs in the first year in order to have connectivity to a global SBI network for existing customers of subsidiary banks. In India there are currently 27 public banks including 19 nationalized banks, six SBI banks, two other IDBI Banks and the Bharatiya Mahila Bank which are classified as other government banks, 23 private sector banks and 46 foreign banks with 325 subsidiaries and 61 regional rural banks (RRBs), as at 31 Dec. 2015 and others. There are also 22 public sector banks in India.

2.2 Structure of Indian Banking Sector

"Banking" implies receiving deposits of money from the public, on demand or otherwise, for purposes of the loan or investment, and cancelation by cheque, draft or otherwise," as specified in paragraph 5(b) of the Banking Regulation Act 1949. "Banking" means acceptance." The Bank of India Act (1934) includes all banks included in the Second Schedule. These banks include planned commercial banks and planned cooperative banks. The scheduled commercial banks are classified by their ownership or nature of activity into five main categories. There are bank classes:

- State Bank of India and its Associates,
- Nationalized Banks,
- Regional Rural Banks,
- Foreign Banks and
- Other Indian Scheduled Commercial Banks (in the private sector).

III. BANKING SECTOR REFORMS

The position and relevance of finance in economic development have been studied and debate on for a long time (Levine, 1997; 2005). A key issue in this literature is why in some countries financial markets are deeper than in others, and what particular policies might accelerate financial growth where it is lagging behind. In this segment, we examine the financial growth results of the policies of financial liberalization that most countries have introduced worldwide and whether they have created deeper financial markets as expected.

The drive to minimize the financial sector position of the government is also driven out by McKinnon's (2010) and Shaw's important work (1973). They argued the fact that state intervention in financial markets was widespread, with low deposit rates resulting in low finance saving, high rates of loan interest, monopoly power, etc. by way of government ownership of banks, interest rate regulation, high reserves, strict entry constraints and compulsory credit allocation to the preference sectors etc.

In keeping with Shaw and McKinnon's guidance, several countries have committed themselves in the last 30 years, although differently and at a different level, to the dismantling of strategies for "financial control." In the last 30 years. A new IMF database follows improvements to several aspects of financial sector reforms, offering the most extensive indicator of financial liberalization to date (Detragiache et al., 2008).

This segment discusses whether financial reforms, as expected by McKinnon and Shaw, have contributed to deeper financial markets. We also examine how the financial sector's reaction to policy reforms has been affected by organizations. A broad range of studies has shown that the cross-sectional growth in the financial sector is clarified by a number of institutional nation characteristics, such as legal roots (La Portaet al. 1998), contracting rights institutions (Djankov et al., 2007) (Roe & Siegel, 2008). This report shows that the institutional climate significantly affects the operation of the financial sector.

Researchers find that policies for financial liberalization improve financial growth across the years, but they only restrict the executive authority in countries with well-developed democratic institutions. The financial changes in other countries had little lasting consequences. This evidence shows that maintaining sufficient political power checks and balance sheets—as a critical measure to enhance property rights protection—may be an essential requirement for the financial sector to work better in the wake of liberalisation. In accordance with Acemoglu and Johnson (2005), more stringent management restrictions affect progress, expenditure and financial development in a considerable way. The view is that democratic controls and balances shield people from the expropriation by politically dominant elites and thus protect ownership of land. Strong proprietary rights security means, in exchange, that future finance sector loans are available as they qualify for all actors in the economy. It also is found that it is not important to shape the responses of financial sector growth to banking reform in other institutions or policies—especially in the quality of financial sector oversight and regulation.

As discussed above, an important literary study focuses also on transversal variations and the determinants of financial growth. Some research investigated the function of macroeconomic influences (Boyd et al., 2001); banks' ownership and the role of organizations (La Portaet al., 2002; Detragiache et al., 2008), as mentioned. Moreover, through checking the theory of Rajan and Zingales (2003), that financial progress continues to take place if markets are exposed to external competition, such that rents for incumbents are eroded, Braun and Raddatz(2008) and Baltagi etal.(2007) discuss political economics-theories of financial growth. Chinn and Ito (2006) reflect on the impact on different indices of financial growth of the removal of limits on foreign financial transfers (capital account liberalization). They consider that liberalization of capital accounts only contributes to stock market growth in countries with adequate laws, while in other countries the result is negative.

Several documents examine the impact of such restructuring episodes in the financial industry. In Rajan and Zingales, for example, (1996) financial development in different countries benefits industries relatively more dependent on foreign finance than other industries. The relaxing of the intergovernmental banking and branching constraints in the United States in the 1980s has led to stronger economic development (Jayaratne & Strahan, 1996) and to more sensitive decisions on bank loans for corporate performances (Stiroh&Strahan, 2003). (Cetorelli&Strahan, 2006). Bertrand et al. (2007) finds in France that bank deregulation has prevented banks from bailing out companies which have contributed to faster industrial restructuring. Bank deregulation in Italy has increased access to credit and lower spreads of interest rates, and has created more unsuccessful credit (Guiso et al., 2006). Tressel (2008) has shown in a broad sample of countries that financial reforms favour sectors that more rely on foreign financing but that the distinctive beneficial impact in countries with low proprietary rights security is weaker.

The economic liberalisation has been correlated with a higher rate of financial crisis incidents (Schmukler & Kaminsky 2003), with greater uncertainty in terms of outputs (Demirgüç-Kunt & Detragiache 1999), yet with a better investment distribution (Galindo et al., 2007; Chari & Henry, 2008, and Abiad et al., 2008). Finally, Agca et al. (2007) look at the transition in business leverage of financial restructuring and globalization. They see domestic liberalization in developing world companies as a function of increased leverages and less leverage in emerging market corporations. They view this result as proof of a lack of cost and access to credit in emerging markets by domestic liberalization.

IV. BANKING SECTOR REFORMS IN INDIA

In 1991, India experienced a severe economic recession. Even for two weeks, foreign currency reserves were too weak to fund our imports. There were no fresh loans open and withdrawal of non-resident assets. The Indian economic structure was almost a worldwide factor in a lack of trust. It was about time we started fresh reforms so that the economy could emerge from this recession and place it on the path of quick and steady growth. In August 1991, under Mr Narasimhan's presidency, the Government named a Financial System Committee.

4.1 First Phase of Banking Sector Reforms/Narasimham committee report 1991

The Narasimham Committee made recommendations to encourage safe financial sector growth. The Government has taken steps since 1991 on the suggestions of the Narasimham Committee:

- SLR and CRR reduction to the transfer of further funds to the agricultural, industrial, commercial etc.
- Prudential standards on all Non Performing Assets require banks to have 100 percent (NPAs).
- The RBI is fixed at 8% by the capital adequacy standards (Capital Adequacy ratio is the ratio of minimum capital to risk asset ratio.)
- The primary loan rate of SBI and other banks for general advances over 2 lakhs was decreased. Deregulation of interest rates
- Debt recuperation Six Special Tribunals for Recovery has been established. In Mumbai, an appeal court was also established.
- New Private Sector Banking Competition The capital share of international institutional investors can be increased to 20% by new private sector banks and up to 40% by NRIs. The rivalry has intensified.

4.2 Second Phase of Reforms of Banking Sector (1998) / Narasimhan Committee Report 1998

The government has named the Banking Sector Reform Committee under M's chairmanship to strengthen the banking sector. In April 19 98, Narasimhan presented his paper. Structural measures and improvements in disclosure requirements and degree of oversight have been more relevant to the Committee. The Committee's proposals were adopted after the reforms:

- New Areas and New Instrument New areas have been opened up, such as: Insurance, credit cards, asset management, leasing, gold banking, investment banking etc. New instruments have been introduced such as: Interest rate swaps, cross currency forward contracts etc.

- Risk Management and Strengthening Technology Banks have started specialized committees to measure and monitor various risks. For payment and settlement system technology infrastructure has been strengthened with electronic funds transfer, centralized fund management system, etc.
- Increase in FDI Limit In private banks the limit for FDI has been increased from 49 percent to 74 percent.
- Adoption of Global Standards and Information Technology Best international practices in accounting systems, corporate governance, payment and settlement systems etc. are being adopted. Banks have introduced online banking, E-banking, internet banking, telephone banking etc.
- Management of NPA RBI and central government have taken measures for management of NPAs such as corporate Debt Restructuring (CDR), Debt Recovery Tribunals (DRTs) and LokAdalts.
- Guidelines For Anti-Money Laundering In recent times, prevention of money laundering has been given importance in international financial relationships. In 2004, RBI updated the recommendations concerning awareness of the values of the client (KYC).
- Basic interest rate system, In 2003, the Benchmark Prime Lending Rate (BPLR) was launched in order to provide benchmarking prices to banks in order to guarantee that the real cost was genuinely represented. The BPLR framework, however, does not achieve its aim. After 1 July 2010, RBI has adopted the basic rate scheme. The basic amount on all loans is the lowest rate. As per 13 October 2010, base rates were between 5.5% and 9.00% for the banking sector as a whole.

4.3 Recent Banking Sector Reforms

- Lowering SLR and CRR

SLR: it means a certain percent of banks' investments in the form of liquid assets. This is maintained by the fund. Liquid assets are government securities, treasury securities and other RBI informed securities. If the SLR is higher than those banks are needed to hold more of the deposits of such shares, banks would have lower surplus loans. That would be lending. In the same way, if the SLR is less than that of banks, fewer deposit pieces would have to be maintained in listed securities. The RBI is determined by the SLR and normally ranges from 24% to 39%. This ratio is now 21.5.

CRR (cash reserve ratio): Reserve bank controls cash reserve ratio of commercial banks. It is obligatory for commercial banks to maintain this ratio.CRR is the minimum cash reserve that every bank has to maintain with the central bank RBI. If RBI increases CRR then banks will have to maintain more cash holdings with RBI and it will reduce their loan giving capacity. So higher CRR will contract credit. If RBI decreases CRR then banks will have to maintain less cash holdings with RBI and banks will have more of surplus cash for granting loans. So low CRR will expand credit. In 1993 CRR was very high at 14%. Now CRR is4% Along with the interest rate deregulation quantitative restrictions was initiated simultaneously. In 1990, 40 percent of the bank credit was directed towards priority sectors. The reserve requirement pre-emotedmore than 40 percent of the net demand and time liabilities of the banking sector. The amount of money available with the banks for credit was very small. The reserve requirement was progressively brought down in time.

The statutory liquidity ratio (SLR) was brought down from 25 % in 1998 and21.25 % in 2016. The cash reserve ratio (CRR) was also steadily brought down from 10.5 % in 1998 to 4% in 2016.

- **REPO (repurchase auction rate) and REVERSE REPO (reverse repurchase auction rate)**

The two currency policy rates are Repo and Reverse Repo. Repo rate is the rate at which commercial banks can borrow RBI funds. The reverse reversal rate implies the RBI rate for deposits made with the reverse repository rate. Increased repo rate would be credited, with higher interest rates now being provided to commercial banks by RBI funds. Likewise, reverse-reposting would also raise contractual loans because business banks are more likely to retain higher rates for depositing funds with RBI. Depositing further funds with RBI from commercial banks reduces the potential of their loans. Repo is 7.25% in the present year and Reverse Repo is 6.25%. REPO and REVERSE REPO are updated by RBI to monitor commercial banks' growth and expansion loans from time to time.

V. EFFECT OF REFORMS ON INDIAN BANKING SECTOR

One of the significant explanation for the implementation of financial sector reforms was the poor health of banks and financial institutions as seen by profitability and non-performing assets. In the past, the government banks were the main contributors to the defaults and the mounting of the financial system's non-performing assets. But in recent years these metrics have seen some progress, while a good deal needs to be done. There have been substantial gains in both operational and net earnings. For example, the net profits of all public sector banks as a percentage have risen from 0.27 in 1991 to around 0.6 in the late 1990s - Strict commitment to resource suitability and prudential standards and improved private sector competitiveness.

Another significant financial performance metric is the level of non-performing assets. Although the gross and net assets of scheduled business banks have increased in the last few years (except for international banks), relatively the same is true, that is, with a decline in advances and overall assets. In the late 1990s, Aggregate Non-Performing Assets decreased from 4% in 1994-95 to about 3% as a share of overall assets.

The dismantling of an administered interest rate system and the gradual transition towards a market-determined interest rate regime was an important board of the financial liberalization. The progress was progressive but clear. After the mechanism started, the nominal prices have been constantly moving towards the South. Importantly, the true interest has been (and is growing) optimistic, thus liberating itself from financial repression. Although this entails large private-sector funding costs, there are no reasons for any concerns and the corporate sector will now raise funds both domestically and internationally on the stock market. Furthermore, the positive actual interest rates promised well for investments from about 20 percent in 1991-92 to about 25 percent in 2000-01 in the private sector savings.

VI. CONCLUSION

Given the (including causality) link between the development of the banking sector and economic growth, it is not shocking that many emerging market economies are encouraged to pursue adequate banking sector reforms, and indeed many such as India have initiated broad reforms over a long span. However, although the effect of these reforms on banks' efficiency is widely available, mostly distinguishing between banks of various ownership, the impact of such reforms on the financial intermediation mechanism is not well understood. We argue in this paper if changes to the bank system have a beneficial effect on the Indian banking sector. Monetary policy does not impact companies with varying forms of ownership – some of which are optimized for industries where frictions are not the same – nor should it affect companies at different age and scale. These proposals we discuss are in the Indian background, characterized by important reforms in the banking sector and the presence of various styles of companies where some have advantages in relation to credit-market friction mitigation. The study findings show that monetary policy and the corresponding interest rate adjustment in an easy money system do not impact change in bank lending, changes in overall debt and the share of the total debt bank lending for either business. The existing literature is on the transmission of currency policy through the bank channel in India (Bhaumik, Dang and Kutan, 2011). In a strict policy scheme, though, the non-affiliated private companies are more susceptible to currency policy where the adjustments in monetary policy impact other kinds of businesses comparatively least. We often find that smaller companies are far more impacted by monetary policy during tight monetary policy systems than large enterprises.

The policy consequences are two significant. First, there seems to be a monetary policy banking channel at work, which indicates a certain progress in India's financial sector reforms. This is all worth considering changes in emerging-market contexts: greater competitiveness, greater autonomy for disbursements of credit and pricing loans, subjecting banks to prudential standards and developing frameworks for contract compliance Secondly, changes to the financial system alone are simply not enough to alleviate the frictions in credit markets, giving certain companies (such as companies or the state) a vantage point over others, which may contribute to misallocations of credit. In order to resolve latent frictions, governments could have to supplement the restructuring of the financial sector with broader changes in terms of bankruptcy laws and corporate governance.

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