

Financial Liberalization & Economic Growth: Theoretical Overview

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Received:

18/05/2025

Revised:

03/06/2025

Accepted:

30/06/2025

Published:

30/09/2025

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Citation: Elhag, A. E.

(2025). Financial

Liberalization & Economic

Growth: Theoretical

Overview. *Journal of*

Humanities & Social

Sciences, 9(9), 98 – 113.

<https://doi.org/10.26389/AJSRP.D200525>

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Abstract: This study examines the effects of financial liberalization on economic growth through a comprehensive review of theoretical and empirical literature. The research addresses the ambiguity surrounding these effects by employing a descriptive approach, analyzing historical and contemporary studies, and incorporating empirical evidence from developing countries. The findings indicate that financial liberalization generally has a positive impact on economic growth, particularly when prerequisites such as strong institutions, good governance, and macroeconomic stability are in place. However, some studies caution that improper implementation can lead to financial crises. The study highlights the benefits of gradual liberalization, enhanced competition in the banking sector, and the role of Islamic banking in adapting to global financial integration. Recommendations include investing in financial technology, improving workforce training, and strengthening regulatory frameworks to mitigate risks.

Keywords: Financial liberalization, Economic growth, GATS, Banking sector, Developing countries, Regulatory frameworks

تحرير القطاع المالي والنمو الاقتصادي: نظرة عامة نظرية

الدكتور / أبوبكر التيجاني الحاج

شركة ولاء للموارد البشرية | جامعة المجمعة | المملكة العربية السعودية

المستخلص: تستكشف هذه الدراسة تأثيرات تحرير القطاع المالي على النمو الاقتصادي من خلال مراجعة شاملة للأدبيات النظرية والتجريبية. تعالج البحث الغموض المحيط بهذه التأثيرات باستخدام منهج وصفي يقوم على تحليل الدراسات التاريخية والمعاصرة، مع الاستناد إلى أدلة تجريبية من دول نامية. تُظهر النتائج أن تحرير القطاع المالي يُحدث عمومًا تأثيرًا إيجابيًا على النمو الاقتصادي، خاصة عند توافر شروط مسبقة مثل جودة المؤسسات، والحوكمة الرشيدة، والاستقرار الاقتصادي الكلي. ومع ذلك، تحذر بعض الدراسات من أن التنفيذ غير السليم قد يؤدي إلى أزمات مالية. تُبرز الدراسة فوائد التحرير التدريجي، وتعزيز المنافسة في القطاع المصرفي، ودور المصرفية الإسلامية في التكيف مع التكامل المالي العالمي. تتضمن التوصيات الاستثمار في التكنولوجيا المالية، وتحسين تدريب العاملين، وتعزيز الأطر التنظيمية للتخفيف من المخاطر.

الكلمات المفتاحية: تحرير القطاع المالي، النمو الاقتصادي، منظمة التجارة العالمية (GATS)، القطاع المصرفي، الدول النامية، الأطر التنظيمية

1- Introduction:

2.1-The Concept of financial liberalization:

International trade in goods is a relatively simple idea to grasp: a product is transported from one country to another. While trade in services is much more diverse. Telephone companies, banks, airlines and accountancy firms provide their services in quite different ways. The General Agreement of Trade in Services (GATS) annexes reflect some of this diversity. The difference between services trade liberalization and trade in goods liberalization is that, to achieve meaningful liberalization in services trade may require modifications of factor mobility restrictions which may not be needed for goods liberalization. This is recognized in modes 3 and 4 of GATS which effectively relate to capital (FDI) mobility and labour (service provider) mobility.

However, for a number of services, there is no difference distinguishes trade in services from trade in goods. Trade in services is conducted in much the same manner as trade in goods, with the service (say software) produced in one country and supplied cross-border to a consumer in another country. But for many other services, from local phone calls to transportation, the simultaneity of production and consumption implies a need for proximity between the consumer and producer and hence it is necessary for the factors of production (capital and labor) to move to the location of the consumer.

But there is an interesting difference between the two underlined types of trade with relevance to their impact on growth. That can be seen in two distinguishing features of services liberalization: First, the fact that "imports" of services must be locally produced and that liberalization leads to enhanced competition, both domestic and foreign. Second, barriers to entry in a number of services sectors, ranging from telecommunications to professional services, are maintained not only against foreign suppliers but also against new domestic suppliers. Full liberalization can, therefore, lead to enhanced competition from both domestic and foreign suppliers. Greater foreign factor participation and increased competition together imply a large scale of activity, and hence greater scope for generating the special growth-enhancing effects. In fact, if foreign participation merely substitutes for domestic factors and the sector does not expand, i.e., the degree of competition remains unchanged, then there cannot be a positive growth impact on account of the scale effect. Conversely, a larger scale achieved merely by eliminating domestic barriers to entry and attracting domestic resources from other sectors would suffice to generate larger endogenous growth. It is worth noting that increased trade in goods can also have a generalized positive impact on growth. For example, trade in goods enables a country to employ a larger variety of intermediate goods and capital equipment which could enhance the productivity of its other resources. Furthermore, trade in goods makes it possible for a country to acquire technology developed worldwide, especially in the form of embodied capital goods.

2.2-The background:

Since December 1997, banking, insurance and other financial services, became fully subject to multilateral trade rules, under the GATS. Therefore, a country acceding to the WTO will be obliged to open its financial sector. The relationship between economic growth and financial sector development has been extensively studied. Some of these studies highlighted the role of the financial sector in mobilizing savings and consequently enhancing the level of investment and the rate of economic growth. Other writers confirmed that higher levels of financial development are strongly associated with future rates of capital accumulation and future improvements. Moreover, they identified prerequisites under which financial liberalization would be beneficial to developing countries. Which includes, good institutions, high quality of governance and macroeconomic stability. Some studies tried to empirically prove the relationship between financial liberalization & economic growth. They reached very important results, such as, the average level of financial development is very strongly associated with economic growth, financial development precedes growth, financial development is positively associated with both the investment rate and the efficiency with which economies use capital.

On contrast, some writers stated that: "financial liberalization does not always promote economic development because it often leads to devastating financial crises". Therefore, the real issue is not whether financial liberalization is inherently good or bad, but whether it can be done right, i.e., if good institutions, high quality of governance and macroeconomic stability were maintained.

This study strongly recommended the Islamic Banks to offer comprehensive banking services that cope with technological innovations to face challenges imposed by the accession to the GATS and maintain strong ties with foreign banks particularly those with Islamic windows. The study also draws the attention to the possible detrimental effects of financial liberalization that may occur in the developing countries.

Although it is well established in theory that financial Liberalization or globalization of financial services, can help promote economic growth through various channels, there is still no robust empirical evidence that this causal relationship is statistically significant. This points to an interesting contrast between financial openness and trade openness where for the latter many research papers have found positive effects on economic growth (Prasad, Rogoff, Wei and Kose, 2004). In contrast to this, some studies have indicated that - in some cases - financial liberalization was inimical to economic growth because it leads to aggravated financial crises.

In response to this important observation, economists started to enquire into the nature of circumstances or prerequisites under which financial liberalization would be beneficial to developing countries. Among such favorable circumstances they identified good institutions, high quality of governance and macroeconomic stability. Which are important prerequisites for ensuring that financial liberalization will be beneficial for developing countries. Furthermore, the conclusion was also reached that countries which adopt relatively flexible exchange rate regimes and succeed in maintaining fiscal discipline are more likely to enjoy the potential growth and stabilization benefits of financial liberalization (Prasad, et. al, 2004).

However, Claessen and Jansen (2000) stated that countries do not appear to benefit more from financial liberalization if their domestic financial systems remain heavily regulated. A thicket of regulations puts the domestic industry at a competitive disadvantage relative to foreign financial institutions; create distortions and inefficient resource allocation. Some cases confirm the need to consider domestic deregulation and financial liberalization jointly.

The aim of this paper is to review the historical background and the impact of financial liberalization on economic growth.

3- Historical Background:

After a failure to agree at the end of the Uruguay Round (UR), and after signing an interim agreement in July 1995, the negotiations on financial services in the context of the General Agreement on Trade in Services (GATS) were finally concluded in December 1997. The services sector, which includes banking, insurance and other financial services, is now fully subject to multilateral trade rules. Not only did the agreement consolidate the relatively open policies of industrial countries which account for much of world trade in financial services, it also enjoyed wide participation from both developing countries and countries in transition (Mattoo, 2001, pp. 2-3). The GATS mainly outlines the framework on negotiating liberalization of the service sector by member countries and ensures any commitments made are enforced in a non-discriminatory manner. Therefore, it obliges no state to open, for instance, its financial sector to foreign investors. Legally speaking, no acceding state is under any obligation to commit itself to the liberalization of its financial sector. Practically speaking, however, a country acceding to the WTO will be required to open such a sector of strategic importance. In February 2000 the WTO Services Council formally launched a new round of negotiations on services which included negotiations on trade in financial services. The aim was to achieve greater openness and liberalization of trade in financial services between the negotiating parties. The term "financial reform" is used interchangeably with the terms "Financial Liberalization", "Financial Deregulation", and "Financial Deeping" (Wilbert O.Bascom, 1994).

A considerable part of the economic literature on the subject has consistently pointed to the crucial role of financial development in a country's economic growth. It is now almost axiomatic to state that a well performing financial sector promotes economic growth through a multitude of channels, well known among which is the enhancement of the rate of accumulation and efficiency of capital. Indeed, the relationship between economic growth and financial sector development has been extensively studied by researchers. McKinnon (1973) and Shaw (1973) highlighted the role of the financial sector in mobilizing savings and consequently enhancing the level of investment and rate of economic growth. In Fry (1978, pp.464-475) the results of pooled time series cross-section analysis using annual observations for seven Asian less developed countries support the view that financial conditions influence savings and growth. Financial constraints such as interest rate ceilings discourage risk-taking by financial institutions and hence ration out a large proportion of potential investors. King and Levine (1993, pp. 717-737) reached the conclusion that the predetermined component of financial development is a good predictor of long-run growth over the next 10 to 30 years. i.e., the best predictor of the average level of financial development is past financial development. They also confirmed that higher levels of financial development are strongly associated with future rates of capital accumulation and future improvements in the efficiency with which economies employ capital. Abolishing interest rate ceilings through liberalization of international financial flows, contributes to achieving the optimal result of maximizing investment and raising still further investment's average efficiency (Levine, Loayza, and Beck, 2000, pp. 31-77). Mishkin (2007, pp.259-294) argued that the real issue is not whether financial liberalization is inherently good or bad, but whether it can be done

right. In response to this important argument, economists started to inquire into the nature of prerequisites under which financial liberalization would be beneficial to developing countries. They identified good institutions, high quality of governance and macroeconomic stability (Prasad, Rogoff, Wei and Kose, 2007). Needless to point out that, accession to the WTO and more particularly to GATS will intensify the positive impacts of the financial sector on the overall development of the economy if it is done right.

4- The Interactions Between Financial Development and Economic Growth:

All financial systems in market economies, whether they are developed or developing, perform two basic functions: (a) administering the country's payments mechanism; and (b) intermediating between savers and investors. In developing countries, financial systems are stylized by the following facts:

1. They are dominated by commercial banks.
2. They tend to be heavily taxed.
3. The commercial banks are required to maintain high reserve ratios (Fry, 1995, pp.2-5).

The interactions between financial development and economic growth have constituted a considerable part of economic literature since the beginning of the twentieth century. Numerous and diverse ideas and opinions have been expressed on this subject. Examples of these ideas include those briefly presented below:

Schumpeter (1912) stresses the importance of finance in the process of development. He described the entrepreneur by stating that: "He can only become an entrepreneur by previously becoming a debtor". Schumpeter emphasized the relationship between finance and development as follows: "Granting credit in this sense operates as an order on the economic system to accommodate itself to the purposes of the entrepreneur, as an order on the goods which he needs: it means entrusting him with productive forces. It is only thus that economic development could arise from the mere circular flow in perfect equilibrium" (Fry, 1995, p.22).

Goldsmith (1969) illustrated the close ties between financial development and economic development for few countries. He placed a heavy stress on the role of financial services in allowing financial investments to flow to their most productive uses, and hence in generating growth of output and income. He suggested that the ratio of the value of financial intermediary assets to Gross National Product (GNP) was a variable that in some way represented the performance of the financial sector. He used this variable as an explanatory, independent, variable in a regression in which economic growth rates were the dependent variable. He found a statistically significant relationship between the two variables, which he termed a "rough parallelism" between growth performance and the level of financial development.

Along the same lines, McKinnon (1973) and Shaw (1973) proved that financial intermediation will grow with savings as intermediation helps these savings flow from lenders to borrowers. Primarily, the higher level of savings and investment drives the growth of the economy. The ideas of these two Scholars have found supporters. Namely those concluded with the fact that the degree of development of the services sector is associated with stronger growth performance. Significant among them are King and Levine (1993), who presented a set of findings that support the view of Schumpeter, who argued in 1911 that the services provided by financial intermediaries (mobilizing savings, evaluating projects, managing risk, monitoring managers and facilitating transactions) stimulate technological innovation and economic development.

After examining a cross-section of about 80 countries for the period 1960-1989, King and Levine reported three findings:

- A. The average level of financial development for the period 1960-89 is very strongly associated with economic growth for the period.
- B. Financial development precedes growth.
- C. Financial development is positively associated with both the investment rate and the efficiency with which economies use capital.

These findings have been reached through studying the empirical relationship between four financial indicators and four growth indicators. The four financial indicators are: 1- The ratio of the size of the formal financial intermediary sector's liquid liabilities to the Gross Domestic Product (GDP) "i.e. the financial depth" which they termed "LLY"; 2- The importance of deposit money banks relative to the central bank was measured by the ratio of deposit money banks' domestic assets to the sum of deposit money banks' domestic assets and the central bank's domestic assets, and this variable was termed "BANK"; 3- The ratio of credit extended to the nonfinancial

private sector to total domestic credit extended by the banks (excluding credit to money banks) which they called "PRIVATE"; 4- The ratio of claims on the financial private sector to GDP and this variable was termed "PRIVY".

The four growth indicators are: 1- Real per capita GDP growth rate "GYP"; 2- The rate of physical capital accumulation "GK"; 3- The ratio of domestic investment to GDP "INV"; 4- A residual measure of improvements in the efficiency of physical capital allocation "EFF".

At first, King and Levine began their analysis by studying the contemporaneous associations between financial development, growth, and sources of growth. After controlling for initial conditions and other economic indicators – following the tradition of recent cross-country empirical studies of growth, mentioned above, King and Levine found a positive, significant and robust partial correlation between the average annual rate of real per capita GDP growth and the average level of financial sector development over the period 1960-1989.

Second, they explored the "channels" through which financial development and growth were linked. They regressed GYP on the logarithm of initial income (LYO), the logarithm of the initial secondary school enrollment rate (LSEC), and each financial indicator. In addition to this "base" regression, they also included the ratio of trade (export plus import) to GDP (TRD), the ratio of government spending to GDP (GOV) and average inflation rate (PI) to control other economic phenomena.

The regression results show that the four financial development indicators enter with positive and significant coefficients when the dependent variable is one of the growth indicators at the 0.05 level of significance. Therefore, the financial indicators LLY, BANK, PRIVATE, and PRIVY are strongly associated with the development indicators GYP, Gk, INV, and EFF after controlling for initial conditions and common economic indicators. They found that these measures played an important role and implied an econometrically significant relationship. They assessed whether the level of country financial services sector development in 1960 as measured by one of their ratios predicted the rate of growth for the country over the 1960-1989 period and found that the level of financial services sector development in 1960 was a significant predictor of later period economic growth.

However, Arestis and Demetriades (1997, pp.783-799) argued that the generalization of the type postulated by King and Levine (1993) may be misleading and as such offers no help in answering questions on causality links between finance and development. In a quantitative sense, this implies that time series data are much more relevant than cross-sectional data. Also, Easterly, et. al. (1992) argued that, it will be difficult for cross-country growth regressions to explain fully country's growth experience because much of the growth seems to be rooted in the country's specific characteristics that are difficult to capture using data on many countries over long time periods.

Contrary to the above explained relationship between financial development and economic growth rate, some economists argued that finance is a relatively unimportant factor in economic development. Notably, Robinson (1952) contends that financial development simply follows economic growth. Lucas (1988, pp.3-42) termed the relationship between financial and economic developments "over-stressed".

Some writers explore the relationship between financial structure – the degree to which a financial system is market- or bank-based – and economic development. They used Cross-country regressions, industry panel estimations, and firm-level analyses which provide remarkably consistent conclusions. Financial structure is not an analytically useful way to distinguish between financial systems. More precisely, countries do not grow faster, financially dependent industries do not expand at higher rates, new firms are not created more easily, firms' access to external finance is not easier, and firms do not grow faster in either market- or bank-based financial systems. On the contrary, they found that in countries with higher levels of overall financial sector development economies grow faster, industries expand at faster rates, new firms are formed more easily, firms' access to external financing is easier and firms grow more rapidly.

These findings had also been empirically corroborated by some of cross-country empirical studies of growth (e.g., Kormendi and Maguire (1985, pp. 141-163), Barro (1991, pp.407-443), Mankiw, Romer, and Weil (1992, pp.407-437) and Levine and Renelt (1992, pp. 942-963)), which indicated a positive, significant, and robust partial correlation between the average annual rate of real per capita GDP growth and the average level of financial sector development over the period 1960-1989. A well performing financial system is expected to promote growth by positively influencing the rate of accumulation and efficiency of capital. Financial intermediaries play an important role in lowering the costs of researching potential investments, exerting corporate control, managing risk and mobilizing savings. These services will influence savings and allocation decisions in ways that may alter long-run growth rates (Levine, Loayza, and Beck (2000, pp. 31-77). Moreover, Beck and his associates show that countries with legal systems that more effectively protect the rights

of outside investors enjoy greater financial development and economic growth. Thus, it is the overall financial development and not the financial structure that is critical for economic progress. The last statement is of interest to the subject matter of this study.

Some other studies have examined whether the level of development of financial intermediation and the degree of state ownership of banks were determinants of economic growth. For instance, Levine, Loayza, and Beck (2000, pp.31-77) examined the effects of financial intermediation on economic growth in 74 countries for the period 1960-1995 and found that greater financial intermediation had a significantly positive impact on economic growth. The relationship between government-owned banks and the per capita GDP growth was well examined by La Porta, Lopez-de-Silanes and Shleifer (2002, pp.265-301) for 92 countries. They found that higher government ownership of banks resulted in lower per-capita GDP growth during the period 1960-1995, even when initial financial intermediation development had a positive and significant effect. In addition to that, higher government ownership of banks was associated with slower subsequent financial sector development and lower productivity growth. These findings are indicative of the notion that liberalization of financial services is expected to attract foreign banks into the country and hence break the dominance of government owned banks.

5- Liberalization of Financial Services and Economic Growth:

According to Fry (1995, pp. 1-471), liberal attitudes to finance can be traced back at least to the seventeenth century. Among the earlier writers who stressed the importance of sound and unrestricted financial intermediation were John Locke (1695), Adam Smith (1776), Jeremy Bentham (1787), and Joseph Schumpeter (1912).

The accession of a developing country to the WTO is usually followed by a commitment to be made by that country not to discriminate between the member countries when it liberalizes its financial services (Most Favored Nation (MFN) principle). In theory, the liberalization of financial services is supposed to result in a transfer of improved financial services from the more developed countries to the less developed countries, and hence a development of the financial sector in the latter counties. Apart from other benefits, liberalization of financial services helps build more robust, efficient financial systems by introducing international practices and standards; by improving the quality, efficiency, and breadth of financial services; and by allowing more stable sources of funds. In fact, Liberalization of financial services, allows the transfer of innovations and improvements in financial services of the more developed countries to their counterparts in the developing countries. The provision of improved financial services in developing countries will allow for greater efficiency in nearly all sectors of the economy by: expanding the range and quality of these services, allowing transactions that would not otherwise occur, enhancing competition in the export sector thereby and improving the competitiveness of exports. This improvement can also encourage savings and lead to their more efficient utilization. The empirical evidence strongly shows that an efficient financial service enhances economic growth (Claessens and Jansen (2000)). Recently, some writers emphasized the way in which liberalization is implemented. One of those is Mishkin (2007, pp.259-294) who stated that: "financial liberalization does not always promote economic development because it often leads to devastating financial crises". Therefore, the real issue is not whether financial liberalization is inherently good or bad, but whether it can be done right, i.e., if good institutions, high quality of governance and macroeconomic stability were maintained.

The ongoing WTO negotiations of financial services under GATS give countries the opportunity to commit to opening their financial sectors. Safeguards can be built into the process, and liberalization can be phased in gradually. Moreover, this can help to promote economic growth through various channels. However, there is yet no robust empirical evidence that this causal relationship is quantitatively very important. This points to an interesting contrast between financial openness and trade openness, since an overwhelming majority of research papers have found a positive effect of the latter on economic growth (Prasad, Rogoff, Wei and Kose, (2004)).

On the contrary to the above expected benefits of liberalizing financial services, there is a general presumption that poor (developing) countries (like Sudan) stand to lose from global financial services trade liberalization since their domestic financial services industries (e.g., banking services) are inefficient and non-competitive. The implication of this position is that no financial development will be realized in poor countries through trade liberalization of their financial services and the only likely outcome for these countries is that foreign banks will amass their savings and channel them for investment in rich countries (Aql, (2003, pp.291-303)). The expected financial development brought by the poor country's accession to the WTO may be disastrous and not beneficial for the development of

that country. However, according to most of the contributions cited hereafter, financial development contributes to economic growth, a fact which has major implications for policy reform in developing countries.

Before going further, the previously mentioned work of McKinnon (1973) and Shaw (1973) contains econometric evidence which has been widely cited as showing a strong link between financial services liberalization and growth performance. This econometric evidence is supported by Klaus P. Fisher and Martin Chenard (1997), who explored theoretically and empirically the link between financial liberalization and the banking crisis that often follows. They investigated the proposition held by classical development economists that financial liberalization should result in an increase in the supply of funds to the real sector. They concluded that the unambiguous increase in risk to the banking firm which implies a higher probability of a banking crisis following financial liberalization is less formal and the presence of an explicit or implicit deposit insurance scheme is likely to explain the incentives to engage in risk and the risk structure of the banking system. They found that the sign of the change in supply of credit to the real sectors was ambiguous. They tested empirically the propositions resulting from a model containing data for 73 banks from Greece, Malaysia, Mexico, Taiwan and Thailand. The empirical test was based on a system of three simultaneous equations that use a measure of risk, profitability and intermediation as dependent variables. The measure of risk used was the conditional variance estimated using an empirical conditional Capital Asset Pricing Model estimated using an Egarch specification. The tests tend to support the conclusions of the theoretical model, i.e. unambiguous increase in risk and, for the sample used, an unambiguous fall in loan supply as a proportion of funds available. Finally, they draw policy implications with respect to bank supervision and bank failure resolution procedures during the transitional period, and about the so-called 'liberalization sequencing'.

Hwang and Shin (1998) investigated the trend in penetration of foreign banks into the Korean market. They found that the international financial environment has changed fast in terms of globalization, diversification, deregulation and innovation, since the 1990s. Moreover, the development of information and telecommunications technology has led banking institutions to shift from the traditional lending and borrowing activities to multi-financial projects and development of new financial products. Given the regulatory restrictions, it has been confirmed that the extent of penetration remained limited. Foreign banks in Korea have been engaged in foreign currency lending business to Korean corporations and banks, which was funded by their head offices. Since the share of foreign banks has been too minor to bring about serious changes in the charter values of Korean banks and the competitive environment of the Korean banking sector, they focused on their behavioral patterns. They found that foreign banks in Korea were able to provide rather stable foreign currency lending services irrespective of macroeconomic fluctuations of the Korean economy. They argue that allowing commercial presence of foreign banks should be expected to be beneficial in this regard. They concluded that it is too early to make a comprehensive assessment of the impact of the liberalization of banking services. However, they expected that the ongoing restructuring and entry of foreign banks will make the domestic banks more competitive. The management of Korean banks should be independent and efficient. In other words, the Korean banking services should establish both a responsible management system and asset soundness. Also, financial infrastructure should be established through improvements in accounting, credit ratings and payment system.

Claessens and Glaessner (1998) studied the liberalization of financial services in Asia and concluded that, Asian countries should consider the benefits of opening their financial service sectors more quickly - while they are liberalizing capital accounts and deregulating domestic financial markets. The internationalization of financial services - eliminating discrimination between foreign and domestic providers of financial services and removing barriers to the cross-border provision of financial services - is of global interest, especially in Asian countries. But most of these countries limit the entry of foreign financial firms to their financial markets much more than otherwise comparable countries do. Empirical evidence for Asia and elsewhere suggests that this slows down institutional development and that, as a result, it costs more to provide financial services. Asian countries could benefit from accelerating the opening of the financial services sector, in conjunction with the further liberalization of capital accounts and domestic deregulation of financial markets.

Not far from that, Demircuc-Kunt, Levine, and Min (in Lee S. 1998, PP. 83-115) investigated the effects of foreign bank presence in 80 countries from different parts of the world between 1988 and 1995. They found that liberalizing restrictions on foreign banks' entry accelerated the efficiency of the domestic banking sector and thereby contributed to long-run economic growth.

Rahman, Tan and Tan (2004, PP. 45-47) have also indicated that, banking sector plays a pivotal role in the economic development of most Asian countries. After the 1997, full-fledged banking and financial crisis took place in South Asian countries, many banks had to be bailed out by their governments. It is believed that an examination of indicators that led to the problems suffered by

banks in this region will be of enormous benefit. Models were developed for each country that identified banks experiencing financial distress as a function of financial ratios. The study includes the banking sectors in Indonesia, South Korea and Thailand. These sectors are supposed to be ideal for this study, as their banks have enjoyed profitability during the pre-crisis period and were the most severely affected by the financial crisis in 1997. Logistic regression was used to analyze the data sample for the period 1995-1997. In the findings, capital adequacy, loan management and operating efficiency are three common performance dimensions found to be able to identify problem banks in all three countries. It was hoped that the financial ratios and results of the models will be useful to bankers and regulators in identifying problem banks in Asia.

In Europe, Honohan (1999) analyzes the effects of financial sector liberalization in Greece and Portugal. The financial sector in the two countries was known to be highly regulated prior to the introduction of the European Union (EU) Single Market. He stresses that these experiences are of interest to developing countries as these two countries were the least prosperous members of the European Union. In the mid-eighties most of the banks in the two countries were government owned or controlled, and several of them had accumulated large volumes of doubtful and non-performing assets. In Greece, the reforms started with lowering reserve requirements and freeing interest rates. These structural changes had led to significant entry of new banks, but only a few of them were foreign. So, Greece is a case of incomplete liberalization that led to difficulties of monetary control. In Portugal the reforms were more successful. The structural changes brought about were progressive over a period of ten years, starting with the admission of new banks (foreign and domestic) in 1983. This was followed by the removal of interest rate controls, credit ceilings and others in 1988, while privatization of nationalized banks started in 1989. All these processes were accompanied by a strengthening of the legislative framework. These reforms, and others, in the Portuguese banking sector led to the entry of a significant number of banks into the sector. Honohan considered that a success, due to their sequencing and continued implementation. Bottom of Form

Hindley (2000, p.6) reviews the reasoning for arguments concerning the internationalization of financial services; e.g. the potential negative effects of internationalization on domestic financial service providers; the possible difficulties in monitoring and supervising foreign companies; the "infant industry argument" that favors the protection of domestic financial service providers in order to allow them to mature; and the possible lack of commitment to the local economy of foreign firms that would increase the potential for rapid capital flight. Hindley finds that only some of these arguments would call for government intervention, and that there are no cases where protection against foreign competition would be the optimal policy (Claessen and Jansen (2000)). Eschenbach, Francois and Schuknecht in dealing with the issue extended the analysis on the subject matter to consider the links between financial sector openness, financial sector performance and growth performance - not only conceptually, but also empirically, for a large sample of countries. In their empirical analysis, the three authors relate financial sector competitiveness with openness to trade in financial services. They then relate per capita growth with competitiveness. They found that more competitive financial sectors have a higher level of growth, and that competitiveness can be achieved by more financial sector liberalization. Thus, they provide empirical support for the analytical findings of Hindley that protection against foreign competition does not help financial sector competitiveness but, rather, that openness helps competitiveness and, in turn, economic growth (Claessen and Jansen (2000)).

Whalley (2004, pp.1226-1227) displayed the literature seeking to quantify the impacts of trade liberalization in services like (Robinson (1999); Dee and Hanslow (2000); and Brown, Deardorff and Stern, (2002) involves numerical simulation exercises using (typically global) general equilibrium models based on conventional models of trade liberalization in goods. In these exercises, producers' services are typically identified as an input into intermediate production and barriers to service trade are represented in the form of tariff-like restrictions. The size of initial barriers, how they change under liberalization, elasticities and the size of service trade flows, along with relative country size and any differences in market structure then determine results much as in conventional goods models of trade. Several contradictions are noticeable among these studies. For example, Dee and Hanslow produce results showing extremely large gains from services liberalization in the Uruguay Round (UR) for certain developing countries (a 14.6 per cent of GDP gain for China and 5.1 per cent gain for Indonesia). They stated that, over one half of the total gains from goods and services liberalization accrue from services liberalization. In contrast, Robinson (1999) using similar data put the gains to China at 0.34 per cent of GDP, Asian at 1.29 per cent, and South Asia at 1.13 per cent. Using the same data used by Dee and Hanslow, Verikios and Zhang (2000) found losses to Malaysia from telecom liberalization, and losses to Indonesia from financial services liberalization. In addition, they showed only small gains for China.

Eschenbach and Francois (2002) explored dynamic linkages between financial/banking sector liberalization, financial sector competition and growth. They first develop an analytical model, highlighting links between long-run economic performance and the

services trade, through scale economies and market and cost structures in the financial services sector. This is followed by an econometric exercise based on data for 130 countries for the period 1990-1999. Their results point to a strong positive relationship between financial sector liberalization and the growth of the economy. They also point to the presence of scale economies in the sector.

The message of the chapter written by Togan, S. and Berument, H., (2005, pp. 6-42) is that there is tremendous scope for Turkey to benefit from adopting and implementing the legislative, regulatory and institutional framework of the European Union (EU) Banking system. If Turkey had adopted the legislative, regulatory and institutional framework of the EU banking system at the beginning of the 1990's and had enforced these rules, then the cost of the banking crisis faced in 2001 would have been much smaller than the estimated cost of banking crisis of \$53.2 billion. Furthermore, Turkey by adopting and implementing the legislative, regulatory and institutional framework of the EU banking system would lead to an increased competition in the financial sector. They assumed that Turkey will also recognize the Supervisory Authorities' competence of EU Member States and introduce to its Legislature the principle of home country control. With liberalization in financial markets the penetration rates of foreign banks in Turkey are expected to increase substantially causing adjustment costs in the sector. Increased competition will improve the quality and availability of financial services in the domestic market, enabling the application of modern Banking skills and technology, enhance the country's access to international capital, lower prices for consumers and lead to a larger variety of financial instruments. Consequently, the Turkish Banking system is expected to generate considerable benefits for the economy.

Matto, Rathindran, and Subramanian (2006, pp.64-98) examined the effects of financial liberalization on per-capita GNP growth in 59 countries from different parts of the world during the period 1990 – 1999. They found that liberalization of financial services had positive and significant effects on economic growth.

Kiyota, Peitsch and Stern (2007, pp.1-20) focuses on issues of financial sector liberalization of the Ethiopian banking sector. They identified two factors that may constrain Ethiopia's financial development. One is the closed nature of the Ethiopian financial sector in which there are no foreign banks, a non-competitive market structure, and strong capital controls. The other is the dominant role of state-owned banks. Their observations suggested that the Ethiopian economy would benefit from financial sector liberalization, especially from the entry of foreign banks and the associated privatization of state-owned banks.

More recently, Murinde, V. and Ryan, C., (2009, pp.181-207) assessed the implications of the WTO and the GATS for the banking sector in African signatory countries. With emphasis on the free trade element, they first reviewed the relevant provisions of the GATS for banking services and the main exemptions held by African countries. The main efficiency indicators for a sample of the top banks in 18 African economies for the period 1997-1998 were analyzed. They also used univariate statistics to analyze the dispersion of the key bank pricing and liquidity indicators in these economies for the period 1994-1998. The main findings imply that although full liberalization, implicit in the WTO and GATS protocols, will lead to a substantial shake-up of the African banking industry, yet, provided they have an appropriate regulatory framework and allow sufficient lead time, most African countries have little to fear from liberalization at least in terms of the continuing existence of a locally owned banking industry; and indeed, these countries could reasonably expect to be able to restructure and compete, at the very least in African-wide or regional markets. The need to strengthen the supporting institutional framework is even more obvious when it comes to capital account liberalization. Experiences in recent years have shown that achieving the potential gains, and avoiding the risks, of capital account liberalization depend largely on the domestic incentive framework being in place for financial institutions and the strength with which regulations are enforced.

6- Some Potential Economic Impacts of Financial Liberalization:

There are three types of potential economic impacts of financial liberalization. These are positive, negative and mixed. The positive potential economic impacts are presented in several studies. Claessens, Demirgüç-Kunt, and Huizinga (2001, pp.891-911) examined 7,900 banks in 80 countries for 1988-1995 and found that foreign entry improved the efficiency of the banking sector. This is because domestic banks are forced to compete with more efficient foreign banks and because skills and technology levels have improved. Crystal, Dages, and Goldberg (2001, pp.217-266) found that the entry of foreign banks had positive effects on the overall soundness of local banking systems partly because foreign banks screened and treated problem loans more aggressively. Moreover, the entry of foreign banks through financial liberalization may improve bank supervision through regulatory spillover. According to Goldberg (2007, p. 10): "The entry of foreign banks in emerging markets that are healthier than domestic banks implicitly allows a country to import stronger prudential regulation and increase the soundness of the local banking sector". The entry of foreign banks may also contribute to financial

stability in host countries. This is because the cross-border flows are generally more volatile than locally generated claims by foreign branches. As a part of financial sector liberalization, the privatization of state-owned banks may be an important option to further enhance the efficiency of the banking sector. The entry of foreign banks may have positive effects on employment and wages. While studies of manufacturing industries have confirmed that FDI generally had positive effects on employment and wages in host countries, since banks play an important role in financial intermediation, the effects of FDI for financial services on employment may be greater and broader than those of FDI for manufacturing sectors (Kiyota, Peitsch and Stern, 2007, p.16).

Financial services liberalization also carries negative and mixed economic impacts. Several writers have tried to specify the negative and mixed impacts of financial liberalization. Among them is Aql (2003, pp.291-303) who determined three areas for negative impacts. The first is the Lack of fair competition in the presence of strong competitors who enjoy high comparative advantages in terms of financial, human and technological resources. The second is the possibility of siphoning off national savings by foreign financial institutions which invest them in their countries of origin where low – risk investment opportunities tend to be abundant. The third negative impact is represented by the influence of this foreign presence on the monetary policies adopted by the host country given the climate of freedom enjoyed by these financial institutions. In their previously mentioned study, Claessens, et. al (2001) found that foreign entry reduced the profitability of domestic banks. Furthermore, financial liberalization may cause financial fragility rather than financial stability. For example, Demirgüç-Kunt and Detragiache (2001) examined the relationship between banking crises and financial liberalization (defined as interest rate liberalization) for 53 countries between 1980 and 1995. They found that banking crises were more likely to occur in countries whose financial system was liberalized. This is especially true in developing countries where the institutional environment is weak. In their survey article, Prasad, Rogoff, Wei, and Kose (2007) suggested that the positive relationship between financial liberalization and economic growth was rather weak in the case of developing countries. But they found that financial liberalization could be beneficial under the right circumstances such as the presence of good institutions and high quality of governance. Mishkin (2007) noted that if financial liberalization is not managed properly, it can lead to potentially highly disruptive financial crises. This was borne out in Tornell, Westermann, and Martínez (2003, pp.1-88), found that liberalization led to a higher incidence of crises. However, they also found, there was more rapid economic growth in countries that experienced severe credit market imperfections. Some issues of importance to the developing countries are that, foreign banks may not address directly the problems of poverty alleviation, and the access of low-income and rural-based savers and borrowers to financial services. Although financial liberalization itself may have positive effects on economic growth, only wealthy people may gain from financial development. However, according to Mishkin (2007, p. 263): "In countries with better financial development, the income of the poorest fifth of the population actually grows faster than average GDP per capita". That can be attributed to the fact that, financial development enables the poors to access credit more easily.

7- Recent studies:

One of the few studies on cross-country financial liberalization and the economic growth and used the panel data regression analysis concluded to fact that financial liberalization has a significant impact on the economic growth (Eghosa & Ikponmwosa, 2023). A study conducted by (Amjad Ali, 2022), show that financial liberalization has a significant impact on the economic growth. Based on a survey of 54 published articles, and meta-analysis of 906 estimates of the effects of financial liberalization on economic growth. The study conducted by (Borsa Istanbul Review Jan. 2024 pages 1- 13) concluded that the literature contains statistically significant evidence of a positive effect of financial liberalization on economic growth, and, in some cases, these effects can be considered as economically meaningful. Thus, some types of financial liberalization are effective policy tools for increasing an economy's rate of growth even if financial liberalization increases the volatility of the financial sector.

8- Islamic Banking and the GATS:

The sharia-law-compliant system, which prohibits interest, is the national norm in Sudan and Iran, and in a parallel banking system in Malaysia, Bahrain and a few other Gulf States. The development of Islamic finance over the world has witnessed remarkable historical event. The first experimental Islamic banks develop interest-free savings and loans societies were in Pakistan and the Indian subcontinent during the period 1950-1960. Egypt and Malaysia witnessed pioneering ventures in 1960s. New banks were developed during the 1970s as oil money pours into Gulf States. The first commercial Islamic bank opened in 1975 in Dubai " the Dubai Islamic

Bank" and approximately 30 Islamic banks were established over the next decade (Dubai Islamic Bank <http://www.dib.ae>). In 1975 The Islamic Development Bank (IDB), opened in Jeddah, Saudi Arabia. Between 1975 and 2005 it funds more than \$50 billion worth of projects in Organization of the Islamic Conference (OIC) member countries (Islamic Development Bank <http://www.isdb.org>).

Sudan has reformed its banking sector on Islamic principles in 1983 after President Numeiri imposes the sharia law. Dual banking system develops, Islamic in the north, conventional in the south. In 1984, Iran switched to interest-free banking at national level after passing a 1983 Islamic Banking law that was promised in the 1979 Islamic revolution.

By 1985, Islamic financial products offered by more than 50 conventional banks around the globe. Other major banks follow by the 1990s.

The year 1990 has witnessed the establishment of the "International Islamic Accounting Standards Organization, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)" in Bahrain by the IDB (AAOIFI, <http://www.aaofii.com>).

In 2001, Malaysia's Financial Sector Master plan sets target for Islamic finance to make up 20 percent of finance sector by 2010. By 2009, its share of financial assets is about 17 percent. In 2002, International standard setting organization the Islamic Financial Services Board (IFSB) was established in Kuala Lumpur (IFSB, <http://www.ifsb.org>).

In 2004, the Islamic Bank of Britain, the country's first sharia-compliant was opened in London. During the period 2004-2008 the investors' interest in Islamic finance products grows strongly amid steady rise in oil prices and petrodollars flowing through oil producing states. World oil prices peak at over \$147 per barrel in mid-2008 before sliding sharply. In 2008, Global credit crisis and economic slowdown send conventional financial markets into steep tailspin and have chilling effect on Islamic finance as investors avoid risk and asset prices tumble. The Islamic banking system became a risk saver system. As a result, by 2010, Islamic banking and finance became one of the world's fastest-growing economic sectors that comprise more than 400 institutions with assets under management in excess of \$ one trillion (\$ 1,000 billion), (Dubai Islamic Bank <http://www.dib.ae>).

The significance of Islamic banking as a risk saver system has encouraged several researchers to examine its expected performance under the GATS using different sets of data. Islamic Banks are faced by the challenge of financial liberalization, where the financial openness nationally and internationally took various deep dimensions and effects that affected economic and financial systems worldwide.

A study by Ajlouni (2009) aims at forming strategic response to assess the Jordanian Islamic Banks' ability to take advantage of the opportunities that may be provided by financial liberalization and limit its threats, through assessing the capability of Islamic banks to meet the requirements and challenges of financial liberalization, in order to maximize and limit the expected opportunities and threats respectively, has concluded with some results such as: financial liberalization will have negative effects on Islamic banks' autonomy and competitive position. It is also having positive effect through the enhancement of the Islamic banks' ability to create new investment and liquidity management instruments and methods, as well as, the development of the existing ones. In addition to increasing its ability to take advantage of the openness by expanding its operations into new markets.

Omar (1998, pp.47-66) study aims to follow up the implications of the GATS by analyzing the current condition of Islamic banking industry, highlighting the major items of the GATS which are likely to affect this industry. The study concluded by suggesting several measures that would enable Islamic banks to compete fairly with western banks under the call for globalization of markets and liberalization of trade.

Hamoud (1997, pp.1-46) study considers the future stance of Islamic banks within the framework of global Islamic banking system. The study deals with the origins of banking in Islamic culture, the current condition of Islamic banking and finance, as well as the future of Islamic banking under the state of globalization. The study reveals that Islamic banking has achieved partial integration through establishment of Islamic financial institutions. However, such integration is still in need of more comprehensive support to enable Islamic banking system to face the emerging cutthroat competition created by the disappearance of barriers and borders in the domain of trade, banking services, finance and investment.

Igbal, Ahmad and Khan (1998, pp.9-81) concentrates on problems and challenges facing Islamic banking when operating side by side with traditional banks. The study highlighted such aspects as the institutional and legal framework, accounting criteria, lack of joint stock companies as well as challenges related to the operational aspects.

Farah (1999, pp.27-78) deals with the impact of globalization on the economy manifested by the intensive entry of foreign banks in domestic markets, which usually results in weakening the competitive position of national banks and strengthening that of foreign banks. The study also underscored the special character of Islamic banks in terms of depositors and quoted the experience of Dubai Islamic bank as an example. Moreover, Farah emphasized the importance of promoting and supporting Islamic banking through continuous modernization and adoption of technological improvements and advances. He also stressed the significance of deposits guarantee in supporting Islamic banks' deposits. The study analyzed the present situation of Islamic banks and the potential options that fit with the GATS requirements. Based on its prognostication of the expected impacts, it outlined the elements of an appropriate future strategy for Islamic banks.

It is obvious from these studies, that there was a consensus among the researchers that there are some clauses in the GATS which will adversely affect the competitiveness of Islamic banks.

9-The obtained Results:

The investigated studies show that:

- 1- Abolishing interest rate ceilings through liberalization of international financial flows, contributes to achieving the optimal result of maximizing investment and raising further investment's average efficiency.
- 2- The prerequisites under which financial liberalization would be beneficial to developing countries are, good institutions, high quality of governance and macroeconomic stability.
- 3- Accession to the WTO and more particularly to GATS will intensify the positive impacts of the financial sector on the overall development of the economy if it is done right.
- 4- A cross-section study of about 80 countries for the period 1960-1989, resulted in three findings:
 - a. The average level of financial development for the period 1960-89 is very strongly associated with economic growth for the period.
 - b. Financial development precedes growth.
 - c. Financial development is positively associated with both the investment rate and the efficiency with which economies use capital.
- 5- The generalization of the type postulated in the above- mentioned cross-section study may be misleading and as such offers no help in answering questions on causality links between finance and development.
- 6- Finance is a relatively unimportant factor in economic development.
- 7- In countries with higher levels of overall financial sector development economies grow faster, industries expand at faster rates, new firms are formed more easily, firms' access to external financing is easier and firms grow more rapidly.
- 8- An empirical study indicated a positive, significant, and robust partial correlation between the average annual rate of real per capita GDP growth and the average level of financial sector development.
- 9- Countries with legal systems that more effectively protect the rights of outside investors enjoy greater financial development and economic growth.
- 10- The liberalization of financial services is supposed to result in a transfer of improved financial services from the more developed countries to the less developed countries, and hence a development of the financial sector in the latter counties.
- 11- The provision of improved financial services in developing countries will allow for greater efficiency in nearly all sectors of the economy.
- 12- Recently, some writers emphasized the way in which liberalization is implemented. They stated that: "financial liberalization does not always promote economic development because it often leads to devastating financial crises". Therefore, the real issue is not whether financial liberalization is inherently good or bad, but whether it can be done right, i.e., if good institutions, high quality of governance and macroeconomic stability were maintained.
- 13- Liberalization of financial services can be phased in gradually. Moreover, this can help to promote economic growth through various channels. However, there is yet no robust empirical evidence that this causal relationship is quantitatively very important.
- 14- There is a general presumption that poor (developing) countries stand to lose from global financial services trade.

- 15- The implication of this position is that no financial development will be realized in poor countries through trade liberalization of their financial services and the only likely outcome for these countries is that foreign banks will amass their savings and channel them for investment in rich countries.
- 16- The expected financial development brought by the poor country's accession to the WTO may be disastrous and not beneficial for the development of that country. However, according to most of the contributions cited, financial development contributes to economic growth, a fact which has major implications for policy reform in developing countries.
- 17- Liberalizing restrictions on foreign banks' entry accelerated the efficiency of the domestic banking sector and thereby contributed to long-run economic growth.
- 18- The effects of financial liberalization on per-capita GNP growth in 59 countries from different parts of the world during the period 1990 – 1999, were positive and significant.
- 19- There are three types of potential economic impacts of financial liberalization. These are positive, negative and mixed. The positive potential economic impacts are presented by the entry of foreign banks which will improve the efficiency of the banking sector.
- 20- Financial services liberalization also carries negative and mixed economic impacts. The first is the Lack of fair competition in the presence of strong competitors who enjoy high comparative advantages in terms of financial, human and technological resources. The second is the possibility of siphoning off national savings. The third negative impact is represented by the influence of this foreign presence on the monetary policies adopted by the host country.
- 21- Financial liberalization has a significant on economic growth.
- 22- Financial liberalization will have negative effects on Islamic banks' autonomy and competitive position. It is also having positive effect through the enhancement of the Islamic banks' ability to create new investment and liquidity management instruments and methods, as well as, the development of the existing ones. In addition to increasing its ability to take advantage of the openness by expanding its operations into new markets.
- 23- There are some clauses in the GATS which will adversely affect the competitiveness of Islamic banks.

In the light of the above-mentioned results, it can be stated that, financial liberalization - in general - have a positive impact on economic growth. And more likely, when it is done right. Which fulfil, the two Hypotheses:

1. Financial liberalization is beneficial for economic growth.
2. Financial liberalization is beneficial for economic growth under some circumstances.

Therefore, the uncertainty and the ambiguity with regard to the negative impact of financial liberalization on economic growth should be dismissed.

10- Conclusion:

Taken as a whole, the above-cited experiences underline the potential benefits of foreign financial institutions in stabilizing capital flows. Several countries with significant presence of foreign financial institutions benefited from the access of these institutions to foreign capital. More generally, the studies show that the presence of foreign financial institutions can lead to a stronger regulatory and supervisory framework, thus making the processes of capital account liberalization and internationalization mutually reinforcing. This notion is qualified by the need to enact reform policies. The existence of heavy regulations will put the domestic banking industry at a competitive disadvantage relative to foreign financial institutions; create distortions and inefficient resource allocation. The cases of Greece and Portugal confirm the need to consider domestic deregulation and financial liberalization jointly.

Islamic Banks are strongly recommended to offer comprehensive banking services that cope with technological innovations and development to face challenges imposed by the accession to the GATS and maintain strong ties with foreign banks particularly those with Islamic windows.

It is evident from the previous discussion that there are significant economic benefits to be derived from financial sector liberalization, presented by the entry of foreign banks and the privatization of state-owned banks. However, attention needs to be paid to the possible detrimental effects that may occur in the case of some developing countries. Recently, however, some studies prove, empirically, strong evidence of significant impact of financial liberalization on economic growth.

11- Recommendations:

1. Commercial banks in less developed countries are recommended to continue increasing the level of their investments in modern banking services technology, and follow their Central Banks instructions for merging, to improve their abilities to compete on the international level.
2. These banks should diversify their provided banking services, as well as innovate new banking services to meet the increasing demands of their clients.
3. The manpower in the aforesaid banks should be given more attention through training and skills upgrading, that will enable them to use the modern technology more efficiently.
4. Measurement of the banking performance in these countries should include standards such as, efficiency, profitability, a suitable mixture of the provided services and reasonable size of assets and inventories, to enable them to face the strong competition after countries accessed to the WTO.
5. The efforts aiming to enhance the awareness of the public with regard to the banking behavior should be intensified all over the developing country, along with minimizing the required costs and procedures for depositing, borrowing and transfer.
6. The Islamic modes of finance should be clarified to the public, and the amounts and numbers of loans through these modes should be increased.
7. A country with Islamic banking system is recommended to include its detailed Islamic Banking Services in the obligations' schedules to gain the maximum benefits from the facilities offered by the GATS.
8. Caution should be given to the fact that, foreign banks will not be interested to address the problems of poverty alleviation, the access of low-income and rural-based savers and borrowers to financial services.

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