

Plenary Session on Financial Services and Economic Development in Africa: Uganda's Experience with Financial Sector Reform and Lessons for Africa

Louis Kasekende*
African Development Bank

Uganda started financial sector reforms in the early 1990s as part of the broader objective of a shift to market-determined prices and private sector led growth. It was hoped that liberalisation of interest rates combined with a reduction in the participation of government in ownership would promote efficiency in the allocation of resources and promote competition within the sector. The implementation of the initial reforms was slow as there was tension between the broad objective and a residual constituency in support of the role of the state in allocation of resources, facilitating outreach of services to the poor and rural areas, and in setting of prices, especially for interest rates. However, there were other issues of sequencing associated with the reform that were not fully appreciated at the start of the reform. In particular, Uganda opted for a parallel process of implementing reforms in both the commercial and central banking segments of the financial system. This presented a challenge in effective supervision and regulation of licensed institutions. This was further complicated by the transition from a shared role in regulating and licensing of financial institutions between the Ministry of Finance and the Central Bank. The experience of Uganda is quite rich and provides key lessons for a country embarking on a reform of the financial system. The reforms have in a large degree eliminated segmentation arising from distortions from government interference in the price setting mechanism. Significant progress has been recorded overtime on a number of financial indicators including reducing the risk of bank failure. However, the strengthening of a financial system alone does not necessarily provide an efficient and competitive financial system. Liberalisation needs to be complemented by a programme of strengthening the regulatory capacity and framework plus strengthening institutions that support financial reforms such as land registry, commercial courts and credit reference bureaux if the

* Corresponding author: E-mail: l.kasekende@afdb.org

objective of a strong and efficient financial sector is to be achieved. Large margins on interest rates remain, and competition and provision of long-term lending have remained largely elusive. The sale of state-owned bank also presented challenges in its implementation, resulting in a costly and lengthy process. In spite of the challenges in implementation of the reforms, the sector is in a far stronger position when compared with the pre-reform period.

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1. Introduction: Finance and Development

Some economists have argued that the development of financial markets is a critical part of the development process and that an efficient financial system is linked to economic growth. In the world of Schumpeter (1911), a country's financial system was seen to play a critical role in fostering development. The basic services financial intermediaries provide to the economy include mobilising savings and facilitating transactions. These services are essential in fostering technological innovation and economic growth. Goldsmith (1969) and McKinnon (1973) further investigated the importance of financial services and reasoned that better functioning financial systems, as described by Schumpeter (1911) were indeed supportive of faster growth and development. King and Levine (1993) found that higher levels of financial development are significantly and robustly correlated with faster current and future rates of economic growth, physical capital accumulation and economic efficiency improvements. They conclude that the relationship between growth and financial development is not just a contemporaneous correlation: finance leads economic growth.

The financial sector is often regarded as 'strategic' to economic development.¹ Financial services are key inputs in all that nations produce, bring to market, trade in, whether goods, ideas or services. Simply put, financial services are the central nervous system of the body economic (Crockett, 2000).

¹ According to this view, financial institutions should best be owned and controlled by domestic interests (Cornelius, 2000).

The contribution of financial services to economic development is indirect because of their intermediary role and depends on the content of the services provided and on the quality of institutions that provide the services. Arestis and Demetriades (1996) provide evidence which suggests that the causal link between finance and growth is crucially determined by the nature and operation of the financial institutions and policies pursued in each country. An efficient financial system delivers improved credit allocation and a higher quality of financial services. High-quality financial services can result from increased competition between financial institutions. Financial systems exist to serve one primary function—to facilitate the allocation of resources across space and time, in an environment of uncertainty and transaction costs (Levine, 1997). The financial system channels resources from savers to investors for longer-term investment.

Efficient provision of financial services is crucial for entrepreneurial growth and commercial success (Levine, 1996; Jacquet, 1997). Entrepreneurial success, in turn, serves the employment, innovation, growth and development prospects of the host country. Financial services mobilise savings and allocate capital to more productive uses, both of which help increase the amount of physical capital and its productivity. By this, financial services increase economic growth; however, it is widely accepted that the contribution of financial services to economic development is higher in liberalised regimes. This is because financial repression and the implied credit rationing distorts resource allocation and distribution and, as a result, productivity, growth and development are stifled.² Further, Shaw (1973) argues that distortion of financial prices including interest rates and foreign exchange rates reduces the real rate of growth and real size of the financial system relative to non-financial variables. Financial repression would thus seriously retard the development process. On the contrary, the World Bank (1993) finds that a policy of moderate financial repression at positive interest rates may have boosted aggregate investment and growth in the high performing Asian economies by transferring income from depositors, primarily households, to borrowers, primarily firms.

² McKinnon, R. (1973) *Money and Capital in Economic Development*. Brookings Institution: Washington DC.; Fry, M.J. (1982) *Models of Financially Repressed Developing Economies*; *World Development*, 10(9): 731–50.

King and Levine (1993) assessed the connection between banking sector development and the sources of economic growth and found that financial development was positive and significantly correlated with economic growth. Reinhart and Tokatlidis (2001) in a study of 50 countries found that financial liberalisation appears to have positive impact on financial deepening as measured by the credit and monetary aggregates, but that low income countries do not appear to show clear signs of such a benefit. Indeed, Berthelemy and Varoudakis (1996) found negative correlation between financial development and growth on the basis of the panel data regressions run over the period 1960–90 for a sample of 82 countries and concluded that there exists a threshold effect associated with the existence of multiple equilibria in the long run between finance and growth. Demetriades and Hussein (1996) studied 16 developing countries and found that although for half of the countries the granger causality runs from financial development to growth, the relationship for the other half of the countries was in the opposite direction, where causality runs from growth to finance and therefore confirmed the argument that generalisations based on cross-country studies on this debate can be misleading. They concluded that the relationship between financial services and economic growth and development was very country-specific.

Much of the evidence on the relationship between finance and growth uses bank-based measures of financial development such as the ratio of bank deposits to nominal GDP. More recently, the emphasis has shifted to stock market indicators and evidence shows that the role of stock markets could potentially be substantial. Levine and Zervos (1995) argue that well-developed stock markets may be able to offer different kinds of financial services than the banking system and may, therefore, provide a different kind of impetus to investment and growth than the development of the banking system. Increased stock market capitalisation, measured by the ratio of stock market value to GDP, may improve an economy's ability to mobilise capital and diversify risk. They find that the measures of banking and stock market development are robustly correlated with current and future rates of economic growth, capital accumulation and productivity improvements and conclude that stock markets provide different services from banks.

Atje and Jovanovic (1993) also find a significant correlation between economic growth and the value of stock market trading

relative to GDP for 40 countries over the period 1980–8. In principal, a well-functioning stock market should affect economic development through channels similar to those by which the equilibrium interest rate is expected to influence it. Although King and Levine (1993) emphasise the merits of financial intermediation with respect to the promotion of technical progress and entrepreneurship, Allen (1993) stresses that stock markets can effectively take on the risk sharing, monitoring and screening functions with respect to new investment projects. There is a general agreement that banks and the stock markets are the two main channels of financial intermediation and that they compliment each other. However, Atje and Jovanovic (1993) are of the view that although stock markets positively affect growth, raising it by a huge 2.5% per annum, banks have little influence.

2. Financial Sector Liberalisation in Africa

The importance of the financial sector has motivated the concern that state-dominated monopolistic, inefficient and fragile banking systems in Sub-Saharan Africa could have been a major hindrance to development (Peiris, 2005). In this vein, enhanced competition and efficiency in the financial system can lead to greater financial stability, product innovation and access by households and firms to financial services, which, in turn, drives economic growth. Even under imperfect market conditions that constrain competition, liberalisation can still increase economic efficiency through improved allocation of resources. (Aleem and Kasekende, 2003; Kasekende and Ssebudde, 2003).

In tune with most banking systems in some parts of the world, the financial sectors in Africa used to be heavily regulated. The regulations affected market entry and exit, capital adequacy levels, reserve and liquidity requirements, deposit insurance and determination of interest rates on deposits and loans. The purported rationale for the regulations and restrictions was to aid the expansion of the reach of financial institutions, while preventing excessive competition for funds. The restrictions were expected to enhance safety, soundness and increase profitability. Most importantly, the reforms would lead to an optimal allocation of resources at affordable rates. However, this policy regime closed the financial system, rendering it immune to disciplinary forces of competition.

Rather than increase productivity, this policy regime also generated significant inefficiency in the use of resources in the banking sector.

More recently, however, the financial sectors in Africa have undergone reform³ and liberalisation in tune with changes affecting financial systems around the world. Bonaccorsi di Patti and Hardy (2005) and Fanelli and Medhora (1998) summarise the reforms, which have been implemented in a number of countries around the world. The reforms have affected the licensing of private local institutions, the lifting of barriers to entry of foreign institutions and the privatisation of state institutions. The reforms have also involved the introduction of market-based securities, the liberalisation of interest rates, the removal of quantitative restriction on lending and the tightening of prudential regulation. In a number of countries, the financial sector has witnessed improved supervision, and higher core capital requirements have been placed on financial institutions.

The above reforms have impacted on the financial sectors in two main ways. First, the reforms have modified the environment under which institutions operate. The reforms that have changed the operational environment include those deregulating interest rates, eliminating directed credits, liberalising foreign currency holding and introducing market-based systems of monetary policy management. Secondly, the reforms have affected the competition of financial institutions. Financial sector reforms that have affected competition in the sector include those that have led to changes in management and ownership, those leading to technological change and those underpinning new regulations on treatment of non-performing loans and provisioning for loan recovery (Bonaccorsi di Patti and Hardy, 2005).

3. Uganda's Experience with Financial Sector Liberalisation

The Ugandan economy has reaped benefits from comprehensive economic reforms that have been consistently implemented since 1987. Economic liberalisation and prudent policies generated relatively robust growth and low inflation. Although the banking sector

³ The principal aims of the reform processes have been to raise the level and efficiency of the allocation of investment and to enhance the provision of financial services to all sectors of the economy. Liberalisation and reform were meant to boost efficiency and competition by enhancing the role of the market and limiting state involvement.

dominates the financial system in Uganda, it is fundamentally sound and poses no threat to the country's macro-economic stability.

The Ugandan financial system has undergone substantial legal, structural and institutional reform over the last decade. The financial sector reforms were carried out with the objective of boosting efficiency and productivity of banks. The main mechanism for efficiency improvement was to allow competition by limiting state interventions and to enhance the role of the market. One of the initial reforms involved the freeing of the mechanism of interest rate determination. In April 1992, the sale of treasury bills through periodic auctions for monetary policy purposes commenced.

The liberalisation of interest rates was followed almost immediately by changes that led to market-based determination of the external value of the shilling in 1993. Some of the changes in the foreign exchange market included the granting of permission to residents and non-residents to hold foreign exchange deposits. To expand the financial sector, new types of financial institutions were allowed into the financial market and a premium was placed on the promotion of new types of financial products. To give impetus to market forces, new regulations in the operation of the inter-bank foreign exchange market were adopted.

As early as 1992, some of the directed credit programmes that operated at preferential interest rates were eliminated and in 1993, the inter-bank money market was established in order to improve the financial systems liquidity. For monetary policy purposes, emphasis increasingly shifted to the use of open-market operations. Open-market operations helped improve bank service portfolios, as these were enriched by trading in repo transactions, government securities and bonds.

The health of the banking system has improved remarkably following the closure of several distressed banks, substantial improvements in supervision and the introduction of a risk-based approach as well as the privatisation of the originally dominant state bank in 2002. Regulatory system has been modernised to international standards with the implementation of the Financial Institutions Act (FIA) in 2004.⁴ The tightening of BoU's supervision of commercial banks coupled with the restructuring of weak banks helped promote competition in the banking sector.

⁴ It should be pointed out that the reforms have been protracted. In 1993, a new Financial Institutions bill and BoU charter were enacted, clarifying the role of BoU as a regulator and supervisor.

Furthermore, the advent of the Uganda Securities Exchange in 1997 introduced capital market activity and provided more investment avenues for financial institutions.

Additional government intervention by setting up of the Non-Performing Assets Recovery Trust in 1995 helped to recover the bulk of the unpaid loans on the books of banks.

The divestiture of UCB in 2002, which was the largest bank in the country followed by the sale of government shares in DFCU in 2003, paved the way for improvement in the performance of these two institutions and better competition in the banking sector as a whole.

In the area of bank supervision, unified accounting principles and standard reporting systems were adopted and higher minimum unimpaired paid up capital requirements were placed on banks. To tie up the loose ends, the FIA 2004 was enacted, revising and consolidating the law governing financial institutions and providing for the regulation, control and discipline of financial institutions by the Central Bank. It is against this backdrop that the banking sector has evolved to its current state. The policies in which progress was made include privatisation of the state-owned bank, the clean up of small banks from the system, substantial improvements in bank supervision with the introduction of a risk-based approach and passage of the FIA; banks are now well capitalised, profitable and resilient.

4. Constraints Affecting the Contribution of Uganda's Financial Sector to Development

Although the Ugandan banking system has attained some degree of outreach and has recently invested heavily in physical infrastructure such as branches and ATMs, it remains small. The total number of deposit accounts held in financial institutions in September 2004 was just over 1.7 million or about 35% of the total number of households. The Ugandan banking system is, therefore, relatively small even by African standards, and it is underdeveloped and characterised by a large share of foreign ownership and the level of concentration is relatively high. Liquid liabilities, bank deposits and private credit to GDP are below the overall average for Sub-Saharan Africa. The banking system also intermediates a smaller share of

deposits into credit to the private sector. Table 1 provides comparable financial intermediation measures.

Pension funds include the NSSF and Public Sector Pension Fund (PSPF). Micro-finance institutions refer to those applying for Micro-Deposit taking Institution (MDI) status and large scale Micro-Finance Institutions (MFIs).

The financial system is affected by a number of structural, institutional and operational constraints that continue to affect its ability to support economic development (Table 2).

There is need to address risks from small financial institutions.

The payment system needs to be further improved and out reach expanded.

Although banking supervision has improved, there are areas that still require further enhancements.

There is an urgent need for pension system reform and to address issues related to long-term development financing.

Financial intermediation remains low both in relative and in absolute terms. Because the Uganda's financial system has small

Table 1: *Comparable Financial Intermediation Measures*

	Private credit/GDP	Liquid liabilities/GDP	Bank deposits/GDP	M2/GDP	Loans/deposit
1993					
Kenya	19.9	34.8	34.3	40.3	57.9
Tanzania	8.7	25.5	19.6	25.5	44.5
Uganda	4.1	10.3	7.0	10.3	59.1
2003					
Kenya	18.5	35.8	29.4	37.1	63.0
Tanzania	10.8	28.1	17.3	24.4	62.4
Uganda	5.9	19.0	14.7	19.0	40.0

Source: World Bank (2005), IFS (2004) and Bank of Uganda (2004).

Notes: Private credit/GDP is the total claim of financial institutions on the domestic private non-financial sector as a share of GDP. Bank deposits/GDP is the total deposit in deposit money banks as a share of GDP. Liquid liabilities are liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of banks and non-bank financial intermediaries) as a share of GDP. Loan–deposit ratio is the aggregate ratio of lending to the private sector to total deposits for deposit money banks. The underling data are from International Financial Statistics (IFS, 2003).

institutions with small borrowers and small market size, it is difficult to exploit economies of scale and scope.

The system faces relatively high credit risk and low level of competition and these factors are also partly responsible for high interest rates charged to borrowers.

In addition, lack of credit information sharing on borrowers, fraud, weaknesses in land and company registries and deficiencies in insolvency laws and their administration increase credit risks for financial institutions. Financial institutions also incur high evaluation, monitoring and enforcement costs.

The high interest rate spread is also a reflection of limited competition within the financial system. The lack of credit information sharing while increasing credit risk and costs for financial

Table 2: *The Structure of Uganda's Financial System*

Number of institutions	1993	2003	2004
Commercial banks	16	15	15
Other non-bank credit institutions		7	7
Securities companies		8	12
Pension funds	2	2	2
Insurance companies		19	19
Micro-finance institutions		9	9
Credit unions and cooperatives		74	74
Memo items:			
Number of bank branches	229	128	131
State-owned banks	1	0	0
Majority foreign-owned banks	5	12	12
Majority foreign-owned banks (% of total assets)	37.7	87.6	86.9
Total capital/risk-weighted assets	- 11.6	16.7	20.6
Non-performing loans/total gross loans (or exposures)	39.6	7.2	2.6
Annualised return on average assets		6.3	4.5
Liquid assets/total deposits	28.9	83.7	58.4

Source: Bank of Uganda (2005) and World Bank.

Table 3: *Comparable Financial Intermediation Measures*

	Overhead costs	Interest margin
Uganda	7.9	12.7
Kenya	6.1	9.2
Tanzania	7.0	7.5
SSA	6.1	7.9
Low-income	5.9	7.8

Source: World Bank (2005). Overhead costs are banks operating costs relative to total earning assets, whereas interest margin is the interest revenue relative to total earning assets. This is from Bankscope (2001).

institutions also undermines industry competition, as borrowers cannot stop for services on the basis of established track record.

The financial system offers a limited array of products most of which are limited to the short end of the maturity curve. Leasing and housing finance suffer from lack of medium- and long-term funding sources. Institutions that should provide long-term savings and investments such as pension funds, insurance companies and capital markets still face a number of challenges.

The banking system is sound but not efficient as reflected in the high spreads paid by borrowers. Net interest margin and overhead costs are higher than in other countries in East Africa (Table 3). The high operating costs stem from the small size of the banking system to recent efforts to expand outreach.

5. Policies to Enhance the Contribution of Africa's Financial Sector to Development

5.1. *Improving Reach and Efficiency of the Financial System*

In a number of African countries, it is important to improve the environment to support lending and foster greater competition. This would reduce costs faced by institutions and increase efficiency. Reduced costs and increased efficiency are required for financial institutions to provide a wider range of services to a larger population and increase their role of supporting economic development. In many SSA countries, providing support to high performing micro-finance institutions may be what is required to improve outreach. It is important to

accelerate the establishment of the credit reference bureaus in African countries so that through improved disclosure of bank-related charges, the costs of finance are reduced. To reduce credit risk, it is important for some countries to revamp their land and company registries and pass insolvency legislation that gives creditors the rights to commence bankruptcy procedures. An environment that encourages competition will eventually lead to expanded access to the payment systems in Africa.

5.2. Improving Financial Services Technology and Infrastructure

Technological innovations and improvements in communication should improve delivery of financial services in Africa and ultimately enhance economic development. In a number of African countries, financial institutions have responded to these technological innovations and new financial products and services have been introduced to meet customers' needs. Some of the key products introduced include the following.

- (i) *Real-Time Gross Settlement System (RTGS)*. RTGS is an inter-bank credit transfer system, in which large time sensitive payments are settled immediately and individually on gross basis. In Uganda, this service was established in February 2005. RTGS is expected to play a significant role in promoting macro-economic stability and development of the financial sector. The system has a number of advantages including the reduction of the long clearing cycles for traditional settlements, strengths the management of risk in payment systems and promotes efficiency and competitiveness through expeditious funds transfers. For the central banks, the system improves monetary policy management through timely availability of data on monetary flows in the financial system.
- (ii) Development and extension of Electronic Clearing System to rural areas in Africa will help to reduce cheque clearing cycles.
- (iii) Networking of branches and Auto-Teller Machines (ATMs) in Africa through wide area networks should therefore enable customers to transact from any convenient branch. The number of ATMs should be increased tremendously. ATMs reduce queues in banks, improve the

- process of cash withdrawals and allow 24 hour access to banking services.
- (iv) Payment switches need to be set up in a number of African countries. Setting up ATMs is expensive for individual banks. These costs can be reduced if banks connect to electronic switches that allow sharing ATMs.
 - (v) Debit and Credit cards need to be popularised in a number of African countries where they are not yet introduced. Debit cards enable their customers to purchase in retail outlets and help to replace cash for purchases from places where point of sale terminals exist. Payment switches can promote the use of debit and credit cards in the payment system and facilitate customer payment for utilities.
 - (vi) Internet and telephone banking should be supported in African financial sectors. Improved communication networks have already helped banks to introduce Internet banking to enable clients transfer funds and receive statements from banks. Telephone banking also enables customers' to access account balances in a timely manner.

5.3. Increasing Domestic Savings to Support Investment

It is important to take steps to restructure and reform the pension system, promote long-term financing and further develop capital markets. These important reforms will provide markets and instruments for the population to save and invest, to increase term financing necessary for growth and to reduce dependence on donor financing.

5.4. Continue Efforts to Improve Prudential Supervision and Regulation

Although some countries have passed the FIA and laid the groundwork for risk-based supervision, the challenge is to consistently and fully implement these new initiatives. In a number of African countries, prudential regulations need to be updated and further institutional capacity building implemented in the areas of deposit insurance and insurance regulation.

5.5. Strengthen Corporate Governance in Financial Institutions

Institutions should be encouraged to establish their own control systems to enable them manage risks. Already increasing financial

innovation and application of superior systems has complicated risk profiles and paused new challenges to financial managers. Therefore, management of financial institutions should establish prudent risk management systems, which can effectively identify, measure, monitor and control inherent risks in their business operations in a timely manner and on a continuous basis.

5.6. Continue to Improve the Conduct of Monetary Policy

Improvements in liquidity management and forecasting in conjunction with the Ministries of Finance will be required to help anchor market expectations, reduce interest rate volatility and maintain price stability. Public confidence in medium- to long-term macro-economic stability is vital if intermediation in Africa is to deepen. Deep financial markets should also further enhance liquidity management. In the same vein, a comprehensive strategy for government debt management will be required in a number of SSA countries.

5.7. Reduce the Dependence of African Economies on Agriculture

This is an area that is important for financial sector development and needs to be appropriately managed. In a number of African countries, gaps remain in the provision of deposit and payment services in rural areas and in financing agriculture and rural enterprises.

5.8. Evaluate the Dependence on Donor Resources

Although dependence on foreign donor inflows helps reduce poverty and increase investment, in a number of African countries the size of these inflows complicates macro-economic management. Increasing the absorptive capacity will help reduce pressures on monetary and fiscal policies for sterilising large donor inflows. Delays or sudden reductions in aid also pose challenges to macro-economic stability and threaten the stability of African financial systems.

5.9. Improve the Legal and Information Environment

In a number of African countries, the establishment of credit reference bureaus, improvement of legal systems, enhanced transparency of financial costs and broader access to the payment system can help reduce overhead costs and spreads in the medium term. In some African countries, the regulatory structure for banking supervision

has already been thoroughly modernised. In Uganda, for example, the new FIA that was enacted is comprehensive and provides a sound basis for central bank supervision. It is also complemented by the MDI Act designed to extend the central bank's supervision to micro-finance institutions willing to take deposits from the public.

5.10. Need to Strengthen Anti-money Laundering Activities

Legislation is required to combat money laundering and terrorist financing. Central banks should have the technical skills to conduct anti-laundering inspections.

6. Further Research Areas: Improving Linkages Between Financial Services and Development in Africa

Research is required into appropriate measures to improve the contribution of the financial sector to smallholder growth. What package of policies will foster financial sector deepening and enlist the generation of resources for investment financing to ensure that the financial sector is not a binding constraint to growth in Africa? This research should indicate measures to expand access and outreach of the financial system to rural areas. It should identify the institutional, real sector and financial sector constraints affecting access to long-term finance.

Research is needed to understand the scope that exists to increase both public and private investments in a non-distortionary manner to drive the growth process in Africa.

It is important to investigate the underlying sources of high margins and high overhead costs associated with bank lending in Africa and recommend measures to increase intermediation.

Studies are required in aspects of improving the functionality of money and bond markets in low-income African countries.

Research is also vital in improving the effectiveness of monetary policy in African countries. How can policymakers reduce difficulties associated with the money targeting framework when there are questions related to accuracy of the estimated money demand functions or assumptions regarding the stability of money multipliers?

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