**Research
Paper**

Financial Liberalization and Banking Fragility within Tunisian Financial Sector

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Abstract: In this paper we assess and measure the effect of financial liberalization on the Tunisian bank's risk exposure. Our objective is to compute the probability of banking failure. Firstly, we analyze the financial liberalization process and the mechanisms through which financial deregulation may increase banking sector fragility. Secondly, we present an overview of the Tunisian banking sector before and after financial liberalization reforms. Finally, we consider a model to assess the interaction between financial liberalization process and the probability of Tunisian's banks failure. Estimation exercises shows that the increase in loans supply in Tunisian banks is positively correlated to the probability of banking failure. Furthermore, the financial liberalization increases the banking deposits, which are negatively correlated to the probability of banking failure. Our results provide strong evidence of negative relationship between return on banking assets and the probability of failure.

Key words: Financial liberalization, banking fragility, risk exposure, Tunisia

INTRODUCTION

Since independence Tunisia engaged in developing a more efficient production system through several economic development plans. Until the mid 80's, the Tunisian economy was heavily state regulated affecting the financial system with more control. The scope for manoeuvre was narrow as the products which they were authorized to offer, interest rates, credit management as well as core banking policies were directed by the Central Bank of Tunisia. As a result, a competitive banking sector was absent in the economy. In 1986, with the support of the International Monetary Fund, Tunisia had undertaken a *Structural*

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