FINANCIAL LIBERALIZATION AND POVERTY NEXUS: CASE STUDY OF PAKISAN

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ABSTRACT

The linkage between financial liberalization and economic growth has been widely substantiated. However, limited studies have focused on the empirical relationship between financial liberalization and poverty especially in case of Pakistan. Times series data from the year 1984 to 2009 has been used in the present study to explore the impact of liberalization of financial sector on poverty in Pakistan. De facto measure of financial liberalization has been used. Liberalization of financial sector has been proxied by capital flows as a percentage of GDP.ARDL approach to cointegration has been employed to achieve the objectives. The empirical findings suggest statistically significant and long run and short run relation between financial liberalization and poverty
Keywords: Financial Liberalization, Poverty, ARDL.

INTRODUCTION

The process of financial liberalization represents removal of controls on credit and interest rates, letting interest rate to find its' market level, removal of trade and credit restrictions, letting exchange rate to find its' market level and deregulation and privatization of government owned banks with abolition of controls on market entry by banks. FL may have deep effects on poverty in the form of increased availability of financial services and credit for the ordinary people. The advocates of financial liberalization state that it causes financial deepening and improved approach to credit for marginalized poor borrowers and savers. Banks provide more loans because of increased bank deposits owing to higher savings that are made due to higher rates of interest. The larger availability of credit because of higher savings lets the households to borrow and firms to invest. Household borrowing for consumption and borrowing by enterprises for investment increase the levels of economic activity thus leading to more savings and borrowing. Increase in savings rates raise the level of bank deposits and produce higher levels of credit for investment by firms, especially small household based enterprises, and durables consumption. Reducing the reserve requirements add to the amount of credit for a given level of deposits. Moreover, Chigumira and Masiyandima (2003) are of the view that the elimination of entry barriers increases competition among the financial intermediaries and stimulate banks to offer their services to downtrodden and excluded segments of the society. In this way new financial choices are opened up for the poor. Bayoumi (1993) and Ahmad (2007) found positive and significant association between financial liberalization and private savings in United Kingdom and Botswana, respectively. Li, Squire and Zou (1997) using cross sectional data found a strong relationship between financial deepening and reduction in income inequality. Similarly Honohan (2003) found financial depth to be related with lower levels of poverty whereas Dehejia and Gatti (2002) found significant and negative association between financial depth and poverty.

On the other hand, some researchers are also of the view that banks might not extend loans to the poor for various reasons. Chigumira and Masiyandima (2003) argue that bank lending to poor by conventional banks is more costly as compared to large and deep rooted firms because of higher processing and administrative costs and high risk of default. Thus, even after financial liberalization banks may only prefer to lend to established firms because banks are profit oriented. The World Development Report 2001-01 on "Attacking Poverty" states:

"Approach to financial markets is imperative for poor people. Like all economic agents, low-income households and microenterprises can benefit from credit, savings, and insurance services. Such services help to manage risk and to smooth consumption in the face of sharp fluctuations in agricultural yields and prices, economic shocks, and even natural disasters. Savings and credit facilities can help to make larger investments more affordable, and so allow people to take advantage of profitable business opportunities and increase their earnings potential. For economies as a whole, a large literature has documented the importance of well-functioning financial markets for growth. But financial markets, because of their special features, often serve poor people. Asymmetric information between lenders and borrowers creates problems of adverse selection and moral hazard. The traditional solution to these problems is for lenders to demand collateral from borrowers. Since poor people have insufficient traditional forms of collateral (such as physical assets) to offer, they are often excluded from traditional financial markets. In addition, transactions costs are often high relative to the small loans typically demanded by poor people. And in areas where population density is low, physical access to banking services can be very difficult……. Facing such hurdles, poor people are often discouraged and simply do not seek loans since they believe that they will be denied credit or will not be able to fulfill bank requirements. At the same time, conventional banks often find it unprofitable to provide services to poor people using traditional lending practices". (World Bank, 2002:74)

FINANCIAL LIBERALIATION IN PAKISTAN

In pre- reform era, the financial sector in Pakistan was mainly administered by the government. All the domestic banks were nationalized in 1974 and were brought together to form six main commercial banks. In addition household saving schemes and many credit unions were also formed. The main objective of nationalization was to transfer bank credit to some specified sectors and use it for government funding. High domestic borrowing by the government led to financial repression. Bank's portfolios yielded low returns due to five percent reserve requirement and thirty percent of bank deposits to be kept as government securities. The market share of the banks was comparatively low although twenty five multinational banks were in operation. Excessive interest rates were set and the banks were instructed to direct credit to specified sectors. Moreover, prudential regulations were weak. The banks had limited resources and incentive to channelize savings and decrease operating costs.

Liberalization of financial sector in Pakistan instigated in late 1980s on the proposition of World Bank and IMF. The principal objectives of the financial reforms were to accelerate economic growth, develop, strengthen and deepen the financial sector. The reforms of financial sector began in late 80s. The grant of credit to specific sectors was decreased and the interest rates were reduced in 1989-90.The access to financial sector was liberalized by granting a license to ten private banks in 1991. Auctioning of government securities was set up and consistent auctions for six month bills and longer term bonds started in 1991.The bank-by–bank credit ceilings were abolished in 1992.Privitaization began with partial privatization of Allied Bank and Muslim Commercial Bank in 1991.The external account was liberalized in 1994.In 1995 interest rate was loosened along with the introduction of credit deposit ratio system in the market. The partially privatized banks were completely privatized during the period of 1998 to 2001.The barriers to entry to banking sector were abolished to ensure growth of banking sector. The exchange rate was liberalized completely in 2000. Continuing with privatization United Bank Limited was privatized in 2002 and Investment Corporation of Pakistan was liberalized in 2003. Prudent regulations for agri- financing were put into operation in 2005.In 2005 Prudent Regulations for agri-financing were implement that helped banks to start new agri-financing schemes. Prudent Regulations for small and medium enterprise financing and consumer financing were implemented in 2009.

REVIEW OF LITERATURE

A battery of studies has indirectly explored the impact of FL on poverty through its effect on economic growth and only few research studies have paid attention on the direct impact of FL policies on poverty reduction.

Shumpeter (1911) averred that services offered by financial intermediaries are indispensable for economic development. McKinnon (1973) and Shaw (1973) were the first ones to throw light on the issue of financial repression in DCs. They asserted that deregulation and liberalization of financial sector would mobilize savings which would stimulate investment and economic growth. This is because in repressed economies, the negative real rate of interest in financial repression leads to reduction in savings which contributes to low investment and growth rates. It will also culminate into persistent inflation, deregulation of currency and capital flight. Whereas, with higher rates of interest, financial liberalization can attract a large amount of household savings, change them into bank deposits and increase the volume of loanable funds. These result into higher level of investment and speed up growth in the economy. Therefore, with rising interest rates, financial liberalization would increase both savings and productive investment levels. Yeboah *et al* (2010) analyzed the impact of financial liberalization policies on poverty taking into account gender differences at the household level in Ghana. They concluded that incidence of poverty declines as the household get an access to informal or formal credit. They also found that the households headed by males contributed more to incidence of poverty.Khan and Hye (2010) concluded that financial liberalization reduces savings by empirically exploring the relationship between household savings and financial sector reforms in Pakistan on time series data spanning twenty years. Their results showed the financial liberalization index had negative impact on the household savings in the short-run and long run indicating financial liberalization brings savings down instead of increasing them. On the other hand, per capital income, GDP of agriculture sector and international remittances had positive impact on the household savings. Banam (2010) explored the effects of FL on economic growth for time series data from the year 1965 to 2005 in Iran by applying Johansen Cointegration tests. The results showed positive and significant impact of financial liberalization on economic growth whereas ratio of reserve requirement was found to negatively and insignificantly effect economic growth.

Singh and Huang (2011) defined negative link between financial deepening ,income inequality and poverty for thirty seven countries in SSA for the period 1992 to 2006.They concluded that income inequality and poverty could be reduced by financial deepening .On the other hand interest rate and lending liberalization had negative impact on the poor in the absence of institutional reforms. Adam (2011) by employing Johansson Cointegration approach concluded that financial liberalization benefits poor and credit channel to be effective to reduce poverty. He finds positive relationship between FL and economic growth in the long run in Ghana from the time period 1970 to 2007. Arestis and Caner (2008) empirically scrutinized the relationship between poverty and FL by focusing mainly on CAL. OLS and System GMM techniques were applied on the dataset for the developing countries from the year 1985 to 2005. The basic objective was to test if CAL has helped in poverty alleviation and to what extent the impact of CAL on poverty is dependent on institutional quality. Little evidence was found on the hypothesis that CAL mitgated poverty. Ozdemir and Erbil (2008) examined the impact of FL on economic growth and long run income per capita by using longitudinal panel data from 1995 to 2007.They employed *dejure* and *defacto* measures of financial openness and found physical capital formation to have a positive and significant association with growth whereas financial openness had negative association with the growth performance of the countries under scrutiny. Quartey (2005) studied the association between poverty reduction and growth of financial sector in Ghana by using times series data from 1970 -2001. The findings concluded that financial development does not lead to savings mobilization in Ghana .Also, a positive but insignificant impact of financial development on poverty reduction was suggested by the finding. Long-run association between financial development and poverty reduction was also found to be present in this study.

RESEASRCH METHODOLOGY AND EMPIRICAL ESTIMATION

Model Specification
The following model has been estimated to assess the impact of FL on poverty.

$$LnHCR_t = \alpha_0 + \alpha_1 LnFDIL_t + \alpha_2 LnFDIA_t + \alpha_3 LnPL_t + \alpha_4 LnGE_t + \alpha_5 LnUN_t + \alpha_6 LnGin_t + \mu_t \quad (1)$$

Where

The regress and is the natural log of head count ratio and regressors include natural log of FDI liabilities, natural log of FDI assets and natural log of portfolio liabilities. The control variables include natural log of government expenditures, natural log of unemployment rate and natural log of gini index to represent income inequality.

De facto financial liberalization has been calculated as the ratio of total cross-border assets and liabilities to GDP. Data on financial liberalization are from the 'External Wealth of Nations Mark II' created by Lane and Milesi-Ferretti (2007). The components of de facto financial liberalization in percent of GDP include FDI (both assets and liabilities) and portfolio equity (liabilities only). Poverty is measured by Head Count Ratio i.e. the ratio of total poor to the total population. Income inequality is measured by gini index. The data on HCR and GINI is extracted from Zaman *et al* (2010) and Economic Survey of Pakistan. Government expenditures and rate of unemployment are used as control variables. Data source of these variables include Handbook of Statistics of Pakistan Economy and various issues of Economic Survey of Pakistan. Secondary data from the year 1984 to 2009 is used in the current study due to unavailability of data prior to 1984 on proxies of financial liberalization.

The present study has applied ARDL technique by Pesaran *et al* (2001) as the methodology for empirical analysis of impact of FL on poverty. Stationarity of data is not a pre – requisite for ARDL technique. Nevertheless stationarity of data has been checked to find out if the order of integration of data is two because ARDL collapses if data is integrated of order 2.
To check the long run relation between following ARDL equation is estimated:

$$\Delta Y_t = \alpha_0 + \alpha_1 \sum_{j=1}^{k} \Delta Y_{t-j} + \alpha_2 \sum_{j=0}^{k} \Delta X1_{t-j} + \alpha_3 \sum_{j=0}^{k} \Delta X2_{t-j} + \alpha_4 \sum_{j=0}^{k} \Delta X3_{t-j} - \alpha_5 \sum_{j=0}^{k} \Delta X4_{t-j} + \alpha_6 \sum_{j=0}^{k} \Delta X5_{t-j} + \alpha_6 \sum_{j=0}^{k} \Delta X5_{t-j} + \delta_1 Y_{t-1} + \delta_2 X1_{t-1} + \delta_3 X2_{t-1} + \delta_4 X3_{t-1} + \delta_5 X4_{t-1} + \delta_6 X5_{t-1} + \delta_7 X6_{t-1} \varepsilon_{t t}$$

The 2nd step involves the estimation of long run and short run relationship among the running variables. The long run model is projected through following equation:

$$Y_t = \alpha_0 + \sum_{i=1}^{k} \vartheta_{1j} Y_{t-j} + \sum_{i=0}^{k} \alpha_{1j} X1_{t-j} + \sum_{i=0}^{k} \alpha_{2j} X2_{t-j} + \sum_{i=0}^{k} \alpha_{3j} X3_{t-j} + \sum_{i=0}^{k} \alpha_{4j} X4_{t-j} + \sum_{i=0}^{k} \alpha_{5j} X5_{t-j} + \sum_{i=0}^{k} \alpha_{6j} X6_{t-j} + \epsilon_t$$

The Error correction representation of ARDL technique is:

$$\Delta Y_t = \alpha_0 + \sum_{j=1}^{k} \vartheta_{1j} Y_{t-j} + \sum_{j=0}^{k} \alpha_{1j} \Delta X1_{t-j} + \sum_{j=0}^{k} \alpha_{2j} \Delta X2_{t-j} + \sum_{j=0}^{k} \alpha_{3j} \Delta X3_{t-j} + \sum_{j=0}^{k} \alpha_{4j} \Delta X4_{t-j} + \sum_{j=0}^{k} \alpha_{5j} \Delta X5_{t-j} + \sum_{j=0}^{k} \alpha_{6j} \Delta X6_{t-j} + \pi ECM_{t-1} + \mu_t$$

The stability of ARDL model is tested through sensitivity analysis. The sensitivity analysis involves the testing of Serial correlation, Functional form, Heteroskedasticity and Normality. CUSUM and CUSUMSQ stability test is another way to determine the consistency of ARDL model.

Empirical Results

The current study employed Augmented Dickey Fuller (ADF) and Philip Peron (PP) test to test stationarity of the variables. The results of ADF test and PP test are summarized in Table 1.Results of ADF and PP tests in Table 7.1 show that all variables are non stationary at level and stationary at 1st difference. It implies that all the variables are integrated of order one. As none of variables is of the highest order, so ARDL technique can be applied with confidence to scrutinize the impact of financial liberalization on poverty and income inequality.

Table 1: Unit Root Results of ADF and PP Test

	Augmented Dickey Fuller Test(τ)[1]	Phillips-Perron Test ($Z\tau$) [2]

[1] . The equation for ADF test is

$$\Delta Z_t = \beta_0 + \beta_1 t - \delta Z_{t-1} + \sum_{i=1}^{k} \alpha_i \Delta Z_{t-i} + \mu_t$$

Variables	Level	1st difference	Level	1st difference
HCR	-2.522860 (1)	-3.333883(0)**	-2.792000(1)	-3.243221(2)**
GINI	-3.492451(0)	-6.366568(1)*	-3.397162 (6)	-11.48141 (11)*
FDIL	-1.152503(1)	-3.372801(0)**	-3.478721 (3)	-10.28949 (8)*
FDIA	-2.972071(0)	-6.526948(0)*	-2.972071 (0)	-6.163698 (6)*
PL	-2.885876(0)	-6.106091(0)*	-2.694803 (0)	-6.120469 (1)*
EX	-2.947674(1)	-4.304771(0)**	-0.987538 (3)	-3.652886 (8)**
UN	-2.407500(0)	-5.124768(0)*	-1.693422 (3)	-6.098314 (8)*

Optimum lag length is required to estimate the model through ARDL technique and it is found out through Akaike Information Criterion, Schwarz Information Criterion and Hannan-Quinn information Criterion. Table 2 represent the results of selection of optimum lag length of the model .

Table 2: VAR Lag Order Selection Criteria

Lag	LogL	LR	FPE	AIC	SC	HQ
0	106.6693	NA	5.83e-13	-8.305777	-7.962178	-8.21462
1	250.1324	191.2840	2.67e-16	-16.1777	-13.4289	-15.44844
2	390.5045	105.2791*	4.98e-19*	-23.79204*	-18.63805*	-22.42469*

* indicates lag order selected by the criterion
LR: sequential modified LR test statistic (each test at 5% level)
FPE: Final prediction error
AIC: Akaike information criterion
SC: Schwarz information criterion
HQ: Hannan-Quinn information criterion

ARDL approach is employed by following two steps. First step involves testing of the presence of long run relationship among the variables. If long run relationship among the variables exists then we proceed to the second step in which the coefficients of both short run and long run are estimated. (Narayan and Narayan 2007).So to determine the long run relationship among the variables 1st equation of ARDL is estimated. The F test for joint hypothesis is used for testing the existence of the long run relation among the variables with null hypothesis (H_0:δ1 = δ2 = δ3 = δ4= δ5= δ6= δ7= 0). The results of F stat for the existence of long run relationship are reported in Table 7.3. The values of F statistics in Table 7.3 are greater than the upper critical bounds in case of both the models. This shows the existence of long run relationship among the variables.

Table 3: F Test for the existence of Long Run Relationship

F Stat	4.623620	
Critical bound value	**LCB**	**UCB**
10%	2.578	3.858
5%	2.970	4.499

Note: Critical values are taken from Narayan (2005) Table 2 Case 3

Table 4: Diagnostic Tests

Test Statistics		
Serial Correlation	Lagrange multiplier test	1.6809(.195)*
Functional Form	Ramsey's RESET test using the square of the fitted values	.36030(.548)*
Normality	Based on a test of skewness and kurtosis of residuals	.94422(.624)*
Heteroscedasticity	Based on the regression of squared residuals on squared fitted values	.09149(.762)*

*means the rejection of null hypothesis at 5% level of significance.

[2] The equation for PP test is

$$Z_t = \beta_0 + \beta_1 Z_{t-1} + \beta_2 (t - \frac{T}{2}) + \mu_t$$

Results of diagnostic tests in Table 4 verify that there is no serial correlation and variables are normally distributed. Likewise there is no hetroscedastisity problem in the models signifying constant variance. Results of functional form show that there is no specification error in the model.

Table 5 shows the results of estimated long run coefficients of the model. FL has been proxied by FDIA, FDIL and PL. It is evident from the results of Table 5 that FDIL and FDIA are negatively and insignificantly effecting poverty in the long run .Whereas PL is significantly and negatively effecting poverty in the long run .This shows that if FL, when measured by PL, increases by 1% poverty on average decreases by 0 .06 % keeping other variables constant .

Table 5: Estimated Long Run Coefficients using the ARDL Approach

ARDL(1,0,0,0,2,1,2) selected based on Schwarz Bayesian Criterion				
Dependent variable is HCR				
Regressor	Coefficient	Standard Error	T-Ratio	Prob
FDIL	-.058993	.069411	-.84991	.413
FDIA	-.062523	.10744	-.58193	.572
PL	-.060283	.022319	-2.7009	.021
GIN	3.0166	1.2083	2.4966	.030
UN	.12930	.10932	1.1828	.262
EX	-.93990	.18999	-4.9472	.000
C	-4.8824	4.3675	-1.1179	.287

The increase in FL tends to reduce poverty in the long run in case of Pakistan .This finding is in consistence with the findings of Adam (2011), Singh and Huang (2011) and Yeboah *et al* (2010) who found a significant and negative relationship between FL and poverty. The control variable like income inequality is found to have a significant and positive association with poverty. This confirms that high income gaps are one source of increase in poverty. This finding confirms the findings of Akram et al (2011), Fosu (2008) and Ali and Tahir (1998). Government Expenditures also show significant and negative association with poverty as 1% increase in government expenditures decrease poverty by 0.93 % on average, cetrus peribus. Government expenditure seems to have a good impact on poverty reduction in Pakistan. Unemployment shows insignificant and positive association with poverty in long run.

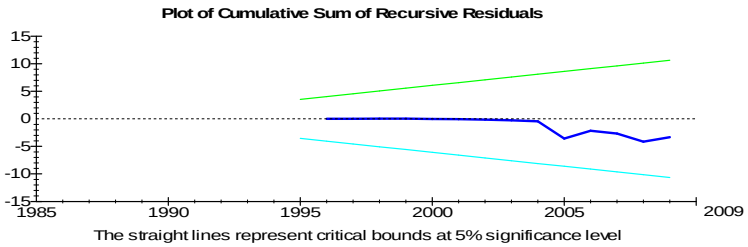
Table: 6 Estimated Short Run Relationship

Dependent Variable : dHCR			
Variable	Coefficient	T- Statistic	Prob –Value
dFDIL	-0.01662	-0.89694	0.385
dFDIA	-0.01762	-0.57429	0.575
dPL	-0.01699	-2.8908	0.012
dGIN	-0.84106	-1.7456	0.103
dGIN1	-3.3709	-5.3859	0.000
Dun	-0.01257	-0.67384	0.511
dEX	-0.20329	-4.4684	0.001
dEX1	0.14039	2.1814	0.047
dC	-1.3758	-1.0668	0.304
ecm(-1)	-0.28178	-4.4038	0.001

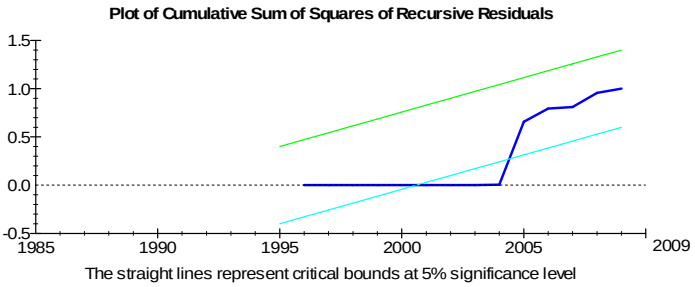
The process of short-run adjustment is observed from the ECM. If the coefficient of ECM lies between 0 and –1, the correction to HCR in period t is a part of the error in period t-1. The coefficient of ECM is -0.28178 and is significant. It implies that deviation of HCR from the equilibrium level in the current period will be adjusted by 28.178 % in the next period. In short run the results of impact of FDIL, FDIA and PL on HCR remains the same. FDIL and FDIA negatively and insignificantly affect HCR while PL significantly and negatively affects HCR. 1% increase in FL will deteriorate poverty by 0.01699 % on average, cetrus peribus. Income inequality and unemployment show insignificant and negative association with poverty in short run .Government Expenditures show a positive and statistically significant association with poverty also in short run. This may be due to various welfare policies made by different regimes over the period of time in Pakistan

The stability of the short and long run parameters have been tested through CUSUM and CUSUMQ stability tests. The graphs of CUSUM and CUSUMQ lay within the critical bounds at 5 percent significance level. This shows that the model is structurally stable and properly specified.

Graph 1: Plot of Cumulative Sum of Recursive Residuals



Graph 2: Plot of Cumulative Sum of Squares of Recursive Residuals



CONCLUSION AND POLICY RECOMMENDATIONS

The implications of these findings are that the impact of FL on poverty is not very large in magnitude in case of Pakistan. Despite the fact it does reduce poverty to some extent .This may be due to the fact that intensity of FL in Pakistan is not very strong .The reason for the this nominal reduction in poverty is due financial development and financial deepening attribute of FL policies. FL channelizes private savings by making private credit available to the poor. It leads to allocation of capital to fruitful uses that in turn increases the human and physical capital and their productivity. FL also accompanies economic growth that trickles down by increasing incomes and reducing poverty.

There has been an extensive research on the relationship and direction of causality between FD and poverty and also on linkages between income inequality and FD but literature lacks a detailed analysis of the impact of liberalization of financial sector on poverty and income inequality especially in case of Pakistan.

The present research contributes to literature a demonstration of statistically significant and negative association between FL and poverty both in long run and short run. Though the coefficients of FL indicators do not show a huge impact on poverty but still the impact is there. Although financial reforms in Pakistan continued since 1970s but still the financial sector of Pakistan is not as developed as it should be. FL is a policy adopted by government and it has significant ramifications on the economy. With positive impact on the economic growth it can also accompany financial instability due to financial crisis it causes in the absence of institutional quality. [Honohan (2004),Beck et al(2007)]. Our results show a minor effect of FL on poverty and income inequality. This affect can worsen if it is not properly thought-through as it can accompany financial crisis as well. Hence the challenge for the policy makers lies in the selection of program of financial reforms that pertinently balances risks and returns. Important policy implication of the empirical findings is that financial markets need to be liberalized further to facilitate savings, investment and financial development since it fortifies the capacity of the poor to gather prolific assets and maintain sustainable livelihoods. Since a large portion of population resides in the rural areas, a viable and efficient rural finance would be essential for providing inexpensive financial services to improve rural income and reduce poverty.

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