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Openness Mitigates Elite Capture and Improves Financial Development: An Analysis of Pakistan

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Abstract:

This paper is an attempt to define elite capture and how elite capture is becoming a hindrance in improving financial development and economic growth? Our main argument is that financial development can be a moderator for economic growth given the elite capture in developing countries like Pakistan. However, the elites do not like to have financial development as it erodes their profits. Therefore, what measures can a country take in this depressing environment to improve financial development which can positively affect growth? We presented a political economy approach of analyzing the state of Pakistan's financial market and proposed openness as a remedy. This remedy not only like to decrease elite capture but also likely to improve financial development. The important character of this remedy is that it will be less resisted by the elites as they will benefit from it as well, so unlike other social and cultural changes this change will met with least resistance. Our result indicates that individually, trade and capital account are beneficial for improving the financial market development. In other words, simultaneous opening of capital and trade account does seem to be a necessary condition for improving financial sector development.

Keywords: Pakistan, financial development, openness hypothesis, political economy, regression analysis, financial liberalization, trade openness

INTRODUCTION

The debate on growth is very old in economic literature. Starting from Smith, there is a considerable literature that suggests various determinants of growth. The macroe Sconomic theory has suggested different channels of growth among which the development of financial markets is well known (Ang, 2008; Levine, 1997). Finance can affect growth in either of two ways (i) Capital accumulation, mainly attributed to Gurley & Shaw (1955) and (ii) total factor productivity channel.

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Levine (1997) suggested important role of financial development towards economic growth. More recently there has been considerable studies that examine the role of financial market on many different economic variables such as income inequality (Taherfar et al., 2023; Ehrlich & Seidel 2019), growth (Ho et al. 2021; Tosunoğlu, B. T., 2023) and external competitiveness (Aman *et al*., 2024). In this context, financial development refers to the efficiency of financial markets to allocate capital to profitable projects and the distribution of assets and investments (Levine, 1997; Levine & Zervos, 1998). An important function of the financial markets is managing capital internationally. With the advent of technology and the globalized economy, financial markets have even more endeavors for investment. Given the complex nature of financial markets, Roubini and Bilodeau (2009) suggested measuring financial market development based on the depth, effectiveness, accessibility, size and stability of the financial markets.

If we look at the literature, we can find different views about financial market development. The debate after getting its momentum in 1973, with the work published by R. McKinnon (1970) and Shaw (1973), the lateral research indicated mixed results. By and large, most of the research indicates a positive role of financial development towards growth (Beck, Levine, & Loayza, 2000; Levine, 2004). The other strand of literature suggests a neutral role or no role in financial development (Robinson, 1952). The rest of the debate is directed more towards its causal relation with growth, where one view suggests financial development cause economic growth and the other view suggests the opposite role (Patrick, 1966; Ağayev, 2012; Ozturk, 2008; Calderon, 2003).

If we analyze the financial markets around the world we can see that especially for developing countries the financial markets are still underdeveloped, which raises a question as to why financial markets are underdeveloped. What developing countries can do to improve financial market development? In this study, we try to find answers to the above questions. The above questions are explored for Pakistan in particular and developing countries in general. Developing countries can benefit from financial market development in both situations i.e. it can play a leading role or it can follow the demand. In both cases, developing countries are in a win-win situation. Given this background, the above question becomes more pertinent. There is some research for example Liang and Reichert (2006) which showed that for developing countries, for financial development to affect growth, the growth must be above a critical level. Under that critical level, the financial development will not be able to bring any effect. This study also quoted Goldsmith (1969), who showed a positive effect of financial development and economic growth for countries that were already considered “prosperous countries”. Meanwhile, Law and Habibullah (2009), and Kenza and Eddiine (2016) favored the demand-following role, where the growth equips the individuals with more money which needs to be managed. Financial institutions then come into the picture and their allocation mechanism brings more growth.

According to Smith(1776), “*No society can surely be flourish and happy of which for a great part of members are poor and miserable*”. In other words, Smith advocated policies that are for the whole society. But unfortunately, if we see developing countries we observe that there are policies which are for the elite class. For example, Pakistan is among the developing countries and according to income, is placed in the middle-income countries (World Bank). Ali (2019) found that over 70 years after the existence of Pakistan, most of the policies made by the rulers benefited the elite community. In its early years of independence, there was a struggle for power grabbing among East

and West Pakistan's politicians. To grab more power, the political elites mostly tried to grasp economic resources. Husain (2009) overviewed the historical evolution of Pakistan's political regimes since 1945 till 2009 and concluded that economic activities were severely affected by the regime change. He was of the view that in fact it is not the regime change but the change of political elites who used to make economic policies. Pakistan, in its sixty years has seen twenty-three civil and four military rules. Therefore, the political instability was also a major factor of economic and financial underdevelopment. However, most of the state reforms including financial sector reforms were carried out under the democratic regimes.

Pakistan has experienced some major political inferences that sabotaged the Pakistan's financial sector significantly. One of those was in 1972, under Z. Bhutto regime, when the government passed an order to overtake 32 industries, and then in 1974, 22 financial institutions were nationalized. It clearly depicts how government policies can hinder the development of the financial market. This abrupt action of the government was reflected the power of pressure groups and political objectives that were tried to be achieved at the expense of industry. Hence, pressure groups and the policies of political parties interfered in the financial markets to achieve political, strategic or distributive objectives. Political interference and elite capture are studied by economists in a branch of literature now known as New Political Economy. The self-interested individuals (industrial elites) and political interference are usually the focus of this new discipline.

The World Bank's country report has presented a gloomy picture of Pakistan. Currently, it is facing its worst economic crisis, which, according to estimates can last longer than expected. The country is facing a fiscal deficit, a current account deficit, low agriculture output, and a difficult business environment. The Pakistan economy was largely affected by the monsoon in 2022, which destroyed infrastructure, crops, and livestock, driving up food prices and further aggravating the economic situation. The country could not get the enough aid to overcome and compensate the loss, and still an approximately US $16.3 million is needed to make up for the loss. Given the above, Pakistan has made a recovery but it's very slow. For the year 2024, the GDP is expected to rise by 1.8 percent. This meagre growth, with a population growth rate of approx. 2%, coupled with high risk makes it more vulnerable to achieve even the above growth. The World Bank has identified at least four areas that have the ability to help Pakistan get out of this recession. It includes the energy sector, private sector development, reaching out to the poor and neglected and the service sector (World Bank 2024).

With the help of political economy theory, we can find reasons why the financial market is underdeveloped even if the central government is pursuing active regulations? The above question will also help us understand why developing countries and developed countries do not have similar levels of financial development. The understanding of the theory will introduce the idea of pressure groups, or so-called elites that affects the development of financial markets. If the financial markets are important, how can we decrease the opposition of such pressure groups or elites to oppose financial development? We would like to suggest the openness hypothesis and, in this context, the Rajan and Zinglaes hypothesis, will help us to understand the solution of the proposed crisis.

For the first question, with the help of a theoretical review and, different theories, we will try to present a holistic view of elite capture and underdevelopment. For the second question, we will introduce the Rajan and Zinglaes hypothesis, which will be tested for Pakistan. The study consists of

five sections. Section I presented the introduction and Section II present the literature review. In Section III we will present the theoretical framework to address the proposed questions which will be followed by estimation results in section IV. The last section V will present the conclusion of the study.

LITERATURE REVIEW

The debate on financial development and economic growth can be referred to Schumpeter (1912), who postulated a positive role between the two. His view was then validated by McKinnon (1970) and Shaw (1973). In fact, after 1973, the debate got momentum, and there was a surge in the literature. Initially, there was a lot of literature that supported this view, like (Beck et al., 2000; Christopoulos & Tsionas, 2004; Imam et al., 2010; Levine & Zervos, 1998). However, if we encompass literature, we find three major directions. The first suggested positive (supply leading) association, the second view, which is opposite to the main view, which related economic growth to financial development (demand following) (Helhel, 2018). The third favors bi-directional relations (Ozturk, 2008), and a small strand of literature go for insignificant relations (Ram, 1999; Shan & Morris, 2002).

An additional finding by Liang and Reichert (2006), in the relationship between financial development and economic growth is the level of economic development a country possesses. According to economic historians, economies that developed financial systems in their earlier years are more prosperous (e.g., Goldsmith, 1969). With economic expansion the size of financial transactions also increases, which creates more demand for financial institutions and more diverse products (e.g., Law and Habibullah, 2009; Kenza and Eddine, 2016).

The contracts in financial markets mostly give rights to both lenders and borrowers for the underlying assets, which are usually financial assets, or real assets and it is important to enforce these rights, otherwise financial markets will not be able to attract investments. According to the law-finance hypothesis put forward by La Porta et al. (1997a) and La et al. (1998) savers would be willing to lend only if they knew their rights were protected. The enforcement of these rights can be a guarantee for investors who are willing to invest, that their investment will be well taken care of. The above protection can be guaranteed in the presence of strong "institutions." According to La Porta et al. (1997) and La et al. (1998), the quality of institutions depends on a country’s legal origins. Daron, Simon, & Robinson. James (2011) showed that initial endowment for any country shapes the quality of institutions in that country. On the other hand, Stulz & Williamson (2003) and Luigi, Paola, & Luigi (2004) have identified cultural or religious aspects of developing financial markets. Beck, Demirgüç-Kunt, and Levine (2003) empirically evaluated the hypotheses and found some evidence in support of both. They argued that where colonizers did not want to or could not settle themselves, in those regions there was a trend that a small elite emerged and took advantage instead of private investors. Meanwhile, where they settled for a long time, they created laws and developed institutions that directly strengthened the creditor rights. However, when comparing both of the theories, they concluded that the initial endowment theory was able to explain the cross country variation in the financial market, and the cultural theory was more able to explain the channel through which financial development was effected.

Finances and money were always a tool for the political governments to play with whenever they wanted to achieve some economic target. For example, the Roosevelt administration used the devaluation of dollar to ease the burden on US farmers, who were overburdened by decreasing income and mortgages (Kroszner, 1999). Khan et al. (2018) defined and identified different types of elites with reference to Pakistan. The world elite is a group of few people, usually in minority who are working or owning different institutions and organizations and are able to influence policy making. Siddiqa (2012) defines the elite as landlords initially and over the years, also includes state's civil and military bureaucracy. Khan et al. (2018) agreed with the above statement and identifies landlords, military, media, judiciary, bureaucracy, religious, dynastic, and industrialist elites. The author suggested two ways to weaken the strength of elites: first, to improve institutions role in the overall setup and second, to give democracy a chance. The democracy overtime can reduce the impact of elites from the society.

If we analyze Pakistan's financial sector, we can find different phases through which it underwent. However, two significant phases are worth mentioning: first, was nationalization in 1974, and the second was financial sector reforms in late 1990. We already talked about nationalization in the introduction. The second phase was opposite to that of the first one, where mostly nationalized banks were de-nationalized. There were structural reforms introduced by the State Bank of Pakistan and the banking sector also saw the beginning of Islamic Banking[3]. Islamic Banking provided the alternate banking for the consumers, and their financing modes deepened the financial market. But at the same time the elites also found a new venue to exert their pressure and found another profitable project for extracting benefits. The same reforms also started the microfinance and small and medium enterprises. (Khalabat, 2011) showed that after the de-nationalization of banks, no doubt the sector has shown growth and profits but most of these benefits were enjoyed by politicians and government officials.

It was quoted by the World Bank's country chief recently that it is high time for Pakistan to decide whether it wants to stay as it is-in poverty, deprivation, and slow growth or it wants to go out of this state (Hussain, 2023). He blames the elite capture for the current situation and points towards both political and business elites. The World Bank estimated 35% of the population is living below the poverty line, which is worsening day by day, and per capita income is lowest in South Asia. The children are pulled out of school and forced to enter job market, thereby increasing child labor. This state is a reality check for its rulers and must be addressed immediately to stop digressing further and entering into the recovery phase. Husain (2009), as a remedy suggested, that timely decisions are the need of the hour and "right" decisions can save the economy. However, the problem is that decision making rests with the Politicians, who already have vested interests. Unfortunately, there is no change in the political power structure in Pakistan. This has also weakened the institutional effectiveness, which resulted in external dependence for finances. The history of Pakistan is mostly characterized by financial aid, grants, and debts for its budgetary requirements. One of the outcomes of such political and industrial cooperation is the failure of all governments to widen the tax base. The failure shows the continuing elite capture in Pakistan, and the result is that existing registered tax payers are burdened every year to decrease the budgetary gap. The electoral policies

[3] Shariah based Banking mostly relies profit sharing modes of financing.

largely encourage holding of state resources and seem not a solution for improving economic situation. The author feared that if it continued like this and the political elite did not take the right decisions, Pakistan may suffer irreparable damage and plunge into a failing state.

METHODOLOGY

This section will try to find the answer to both questions as to what may be the reason for underdevelopment, especially in the financial sector, and the second question: what can a country like Pakistan may undertake to improve financial development? Methodology is divided into two sub-sections. In the first sub-section we will try to postulate theoretically the solution, and in the next section, we will explain the methodology to test our proposed approach.

Proposed Solution: Openness

One of the main reasons for developing countries to lag behind, whether it is economic or financial market-wise, is the intervention of political elites into the economy. Many countries have and are still trying to bring reforms to financial markets. Masciandaro (2009), showed that 84 countries have initiated financial reform of some sort. These financial reforms are aimed-at moving towards more uniformed powers and regulators. However, these reforms are more successful where the "good" policy makers are present. Bordo & Rousseau (2006) also showed that political variables like elections on time, fewer revolutions, and proportional representation are associated with higher financial market development, which in turn affects the growth. It is also a fact that it is the political elite who has to decide when, how, and up to what extent the financial market reform has to be taken.

Ansari (2024) observed similar problems with Pakistan's underdevelopment. According to Ansari, the debate of interference from political elites echoes in Pakistan's economy from time to time. The situation can be referred to the Machiavellian principle, ""The ends justify the means." Just like the Machiavellian principle, Pakistani political elite has also prioritized their personal gains over the welfare of their people. This so called elite capture has let the poor suffer and the poverty trap to widen, thereby increasing unemployment and slowing growth. Ansari (2024) identified the network among politicians and industrial elite who always keep their personal gain first as the main problem of Pakistan's economic turmoil. The political elite works in such a way that they support each other and keep the power in the hands of a few families. Continuing with this approach, political parties function as a vehicle for achieving the above objectives, which cannot bring true reforms to the economic and financial sectors. This also has weakened the institutional quality in Pakistan. The nexus among political and industrial elites working together also deepens the economic challenges in the face of promoting monopolies and oligopolies and letting themselves out of regulatory checks and accountability. It will no doubt hinder productivity and retrogressing institutions. Hence the example of Pakistan and, as such, other such developing nations where the nexus between industrial and political elite has increased the inequality, poverty, extremism, chaos, and unlawful activities.

Lodhi (2023) also agreed with the elite capture view and mostly blames political and business elite for the current situation of Pakistan. The ordeal of Pakistan is the direct result of the power elite, which mostly dominated its politics and controlled the economy, which hindered the development and welfare of the people. The powerful elite, which controls most of the resources has failed to

realize that their strategy is only worsening the affairs. For the very reason of not letting go of these resources, this elite also resists any meaningful reforms. She concluded that this resistance has resulted in the failure of tax reforms, land reforms or governance reforms that were tried in the past.

Ishrat (2020) in his influential book also pointed towards the same elite capture and who has been in power in one form or another from the last seventy years and is responsible for current economic affairs. His main argument was that there is a narrow elite that rigged the market and turned circumstances in their own favor by changing or manipulating the policy side. This undue advantage to them came at the expense of welfare loss to the general public. Armytage(2020) is another book on a similar topic on Pakistan. She has described the psychology of the elite she observed while staying in Pakistan. She observed that mostly the affairs are being run by the political and business elites, which have turned into families that not only benefit themselves but also help each other. The author has termed this a culture of exemption. Most of the wealth is concentrated among these political and business elites. This has resulted in the involvement of the elites in illegal activities and non-answerable to law even. The conclusion drawn by the Armytage (2020) is that given the size of the political elites and strengthening of their roles into dynasties, Pakistan is getting far away from a globalized high-finance economy. Sherani (2023) also believed that political and industrial elites are mistaken to believe that crises being faced by Pakistan is the result of external factors, like the Ukraine war or post-pandemic super cycles. The author gave an example of tax reforms, which were attempted fifteen times since 1972 but no reforms were successful. The elite should realize that the problems facing Pakistan are mostly internal and not external, and elite capture is mainly responsible for underdevelopment.

Now the second question: what can a country like Pakistan may undertake to overcome elite capture that can increase financial development and increase economic growth? There are some ways that are suggested by social scientists to decrease the power holding of the elites. For Example, Khan et al. (2018) suggested to give a chance to many rounds of democracy and to improve institutional quality. Every turn the true democracy will weaken the powers of elites, and at the same time the institutions will make more room for legal rights instead of elites flexing the system for their own benefit. Awan (2023) mentioned that the elite in Pakistan is above the law, and the roots of elite are embedded in the historical evolution that shaped the class system, colonial era and autocracy. He was skeptic over how to break this elite capture and hopeful that there are a few difficult measures that can start a process towards weakening the elite capture. First and foremost, he suggested more political parties representing the middle class and people electing these middle class parties instead of already established political elites. It will give them control over their social, political, and economic problems and their solutions. The second step might be to decentralize the governance and the economic system. When the decisions are made on the grounds presenting middle and poor class, it will be more likely that elites will not be able to extract from them.

In this paper, we suggest measures that are beyond culture and social changes as suggested by many authors. We will present a remedy to decrease the elite capture by way of opening the economy. Openness refers to mainly two aspects: financial openness and trade openness.

Financial openness refers to when capital can freely move to and from a country. Capital account openness is sometimes also referred to as financial openness. Financial openness exerts a positive impact on economic growth and is also helpful to improve financial development as more linkages will be built between the domestic and foreign financial systems. It will improve not only the financial diversity but will also help allocating capital allocation (Hailat and Baniata, 2018). One of the indicators of financial openness is the foreign direct investment (FDI) inflows because they increase economic growth. The way FDI will affect growth is through the introduction of new financial technology and improving the domestic market's competitiveness. However, the allocation of foreign capital will not be efficient if the domestic financial system is not efficient or cannot be at par with the new methods. It may result in a financial crisis, thereby impeding growth. Levine & Zervos(1998) also argued that financial openness can be a key to promote economic growth by way of allocating capital to high return projects. These projects maybe available domestically or internationally, which will increase the size of the financial markets. Financial institutions will be able to diversify risk efficiently and will motivate savers to bring more capital to financial markets. The size, depth, effectiveness, stability, and accessibility will increase thereby promoting financial development and growth (Roubini & Bilodeau, 2009). Financial openness has the ability to lower financial costs, efficient allocation of capital, risk mitigation on an international level, and effect the financial development and economic growth.

On the other hand, trade openness is an old concept and refers to the extent to which a country has access to the global trading system (OECD). Less the restriction, more trade open a country will be. There are numerous studies that look into the relation of trade openness with many economic variables like growth, income inequality, poverty, and stability. A good amount of literature also examines its role towards financial development. Silvia and Cipollina (2024) found trade sanctions to negatively affect financial development. Boosting financial development can mitigate the effect of trade sanctions. It indirectly provides evidence that trade openness increase financial development and growth. Kim (2010) presented evidence in favor of trade openness being crucial for financial development. They took a sample of 88 countries for the duration 1960-2005, and found that a positive relation exists between trade openness and financial development in the long run. For the short run, they found a negative relationship. Svaleryd & Vlachos (2002) argued that the way trade openness affects financial development is through increases in the size of the economic market and, in turn, demand for financial instruments. Therefore, trade openness pushed the financial system to offer new instruments, which compels them to innovate and explore existing financial services offered by financial intermediaries both domestically and internationally. Sghaier (2023) also found a positive relationship between trade openness and the development of financial markets. They conducted research on five African developing countries and concluded that underlying institutional quality and financial conditions and trade openness greatly affect financial development.

Now the most important aspect is to postulate the Rajan & Zingales (2003) hypothesis which may prove to be the solution of elite capture and in turn improve financial development. It can be a soft revolution that will ensure that economic progress may be maintained at some positive rate. Rajan & Zingales (2003) hypothesized that if a country opens up either its capital account or trade account only or as a first move (as suggested by the integration theory), a developing country will not be able to take benefit from it. They suggested a simultaneous opening of capital account and

trade account to get the befit of openness (openness hypothesis). Their line of argument is very interesting and thought provoking. In developing countries, as we argued above, there are political interventions, for example, the government directing the financial institutions to extend credit to a specific sector at subsidized rates or to themselves in exchange for some benefit. Rajan & Zingales (2003) termed the elites in political setup and industrial setup as interest groups or incumbents. Both of these incumbent groups will stand to loose from financial development. That is why they will exert their influence to keep the financial market underdeveloped, for instance, to get cheap credit for themselves. Financial incumbents, based on their personal relationship and inside knowledge, will be able to locate good investment opportunities and get their contracts under the table. Therefore, their profits are jointly determined. Similarly, Industrial incumbents will be able to get their required funding without accessing the foreign markets, which are under more regulation and monitoring. In this environment, new industries cannot enter as they need to get finances from markets that are not available and since capital account is closed, they cannot access the foreign markets. Similarly, financial incumbents enjoy the informational advantage which is mostly based on their relationship with the industrial incumbents. They will also accept weak reporting by the industrial incumbents and based on their relationship with them, work out under the table strategy-hence less regulation. In turn, they will also not be facing any competition in the financial market. New financial incumbents cannot penetrate the market as the existing ones enjoy monopoly powers due to their relation with the industrial incumbents.

Rajan & Zingales (2003) suggested that if a country opens up simultaneously, then the above problem can be addressed. Trade openness along with capital account openness will compel the incumbents to best use the resources available from the domestic and financial sectors in wake of the competition they face from domestic and international new entrants. Lower profits due to competition arising from trade openness, will give them the desire for expanding for which they will need cheap finance which will be available from capital account openness. Government role will most likely be minimized as free flow of capital forces government to maintain regulation and macroeconomic discipline.

The evidence on the openness hypothesis is available for a number of countries and the results are mixed. Some found a positive relation of openness with financial development and growth, and some found a negative relationship. However, this evidence is more based on its effect on either growth or financial development. For example, Huang (2006) showed that financial openness was a key element that is able to describe the cross country difference in financial development. Countries that are more open financially, have a more developed financial system and vice versa. Levchenko & Do (2004) showed that different income countries groups show different relationships of trade openness with financial development. The high income countries are more likely to reap the benefits of trade openness as compared to counties with low income. Azeez (2020) showed a positive relation of openness with financial development. Similarly, Mohamed Sghaier (2023) also found trade and financial openness exerting a positive impact for a sample of five African countries for the period 1991-2015. Zhang et al. (2015) studied Chinese provinces and concluded that the openness hypothesis does not hold for Chinese provinces. However, he found individual effects to be positive and significant. J. Ahmad et al. (2018) also did not find significant results for the openness in Pakistan. Law (2008) also failed to find support for openness hypothesis for Malaysia.

Empirical Model and Methodology

In order to test for our proposed hypothesis we will employ the following model,

$$Ln\,FT = \alpha_0 + \alpha_1 lnG + \alpha_2 lnlaw + \alpha_3 lnKOP + \alpha_4 lnTN + e_t \quad (1)$$

The model that will test the openness hypothesis can be written as,

$$Ln\,FT = \alpha_0 + \alpha_1 lnG + \alpha_2 lnlaw + \alpha_3 lnKOP + \alpha_4 lnTN + \alpha_5 (lnKOP \times TN) + e_t \quad (2)$$

Where, *FT* represents the financial development, *G* is the real GDP per capita, law denotes the rule of law, *KOP* is the variable for financial openness, and *TN* is the trade openness. In equation 2, the term $lnKOP \times TN$ will test the openness hypothesis. We expect *G* to be positively signed which will likely show that as real gross domestic product increases, so does the financial development. We already explained that as *G* increases it will increase the demand for financial services thereby increasing financial development. *Law* is also expected to be positively correlated with financial development (P. O. Demetriades & Andrianova, 2004; Ito, 2006). The individual signs of *KOP* and *TN* can go in any direction but we expect the interaction term α_5 to be positively correlated with financial development. If it's positive, it will validate the openness hypothesis.

This study will use liquid liabilities and ratio of private credit to measure financial development, which is our dependent variable. There are numerous measures available for financial development but mostly have used liquid liabilities and private credit (Beck, 2002; Beck et al., 2000). The data on other variables like, real GDP per capita, is taken from World Development Indicators. The rule of law estimate is taken from the World Governance Indicators. Capital account openness is taken from financial globalization indicators (Lane & Milesi-Ferretti, 2007). Trade openness is measured as the ratio of total trade to GDP, which is a typical measure used by many studies. The source of this indicator is World Development Indicators. This study will use the Ordinary Least Square estimation technique to test our hypothesis.

Estimation Results

Table 1 list the name of the variables and summary statistic whereas Table 2 present the estimation results. We estimated four regression-two for every proxy for financial development with and without the interaction term. To make the Table 2 more understandable, column 1 estimate the equation using liquid liabilities but we did not test the openness hypothesis so as to analyze the individual effects of trade openness and capital account openness. In column 2, we re-estimated the equation using the interaction term, which will test the openness hypothesis. Columns 3 and 4 are then repeated on the same rule but using private credit as a proxy for financial development.

For all estimations, *G* is positively related to financial development at the 5% level of significance. Which shows an increase in income will positively affect financial development. *KOP* is also positively related to *FT,* which is interesting result. However, the significance level is mostly at the margin (10%) and shows weak association. This result validates Rodrik (1998) for Pakistan. Naveed (2017) also found weak association of *KOP* with growth. Other studies like Kose et al. (2006) and Ozdemir, and Erbil (2008)also found mix result for *KOP*. *TN* is individually positive when we include it in the equation without interaction term whereas it becomes insignificant where we include the interaction term. This may present the fact that Pakistan's external

competitiveness is not at the level where it can compete with global players. Pakistan is facing a current account deficit continuously, and that can be a reason for *TN* to be insignificant. Other studies also found trade openness to be insignificant and showed that if combined with other variables like human capital, trade openness will become significant (Din, 2004; Din et al., 2003; Shahbaz et al., 2011) Similarly, the *law* also does not show any relation with financial development. For all estimated equations the sign is positive but shows insignificant results. It can be due to the weak institutional quality environment in Pakistan.

Table 1: Summary of data set (1990-2018, annual data)

Variable	Source	Unit of Measurement
G	World Development Indicators	at 2015 price
Pvt. Sector Credit	World Development Indicators	percent of GDP
Liquid liabilities	World Development Indicators	percent of GDP
TN	World Development Indicators	percent of GDP
Law	Worldwide Governance Indicators	score from -2.5 to 2.5
KOP	lane and Milesi-Ferreti(2007)	percent of GDP

Table 2: Estimation results

	Liquid Liabilities	Liquid Liabilities	Private Credit	Private Credit
lnFD(-1)	0.6325***	0.7015***	0.5866***	0.4587***
	(0.0000)	(0.0000)	(0.0000)	(0.0000)
lnG	0.0125**	0.0144*	0.0358**	0.0432***
	(0.0462)	(0.0726)	(0.0449)	(0.0113)
Lnlaw	0.0254	0.0624	0.3247	0.2399
	(0.7756)	(0.6776)	(0.3210)	(0.4412)
lnKOP	0.0357*	0.05223*	0.0125**	0.0152*
	(0.0775)	(0.0992)	(0.0516)	(0.0857)
lnTN	0.0456**	0.0374	0.0651***	0.1041
	(0.0578)	(0.2650)	(0.0001)	(0.7534)
lnKOP×lnTN		0.1586**		0.0258
		(0.0327)		(0.2351)
R-Square	0.8794	0.8691	0.8571	0.9124
Adj R-Square	0.8123	0.8235	0.8141	0.8676
D.Watson	1.9806	1.9635	1.6957	1.8743
Normality test	5.771(0.5580)	7.6138(0.2221)	1.9045(0.6362)	1.2425(0.8858)

Notes: The figures in the parenthesis are the prob values. ***,**,* indicate significance at the 1%, 5% and 10% level of significance. All estimations are carried out using ordinary least square technique.

For Openness hypothesis, we included the interaction term $lnKOP \times TN$. The result indicates that for the first proxy of financial development, i.e. liquid liabilities, the openness hypothesis is validated, whereas for the second proxy-private credit, the sign of the coefficient is positive but insignificant. There are numerous studies that validate the openness hypothesis (Baltagi et al., 2009; Bandura, 2022; Thuy, Trong, & Lau 2021) and few are not able to establish the positive relationship (Ahmad & Christian, 2019; Demetriades & Law, 2007). The mixed results call for more research on the topic. Our result indicates that if Pakistan open its capital account and trade account simultaneously, it can have positive effect on financial market development. However, for second proxy the openness hypothesis seems not to support our hypothesis. At best we can conclude, that our estimation showed mix results for openness hypothesis. The various diagnostic tests are also validated for all estimations. Normality test also suggests data coming from normal distribution. R-Square is also having a fair value, which suggests sufficient variation in FT is able to be explained by independent variables.

CONCLUSION

This paper tried to explain the underdevelopment in Pakistan in the context of its financial market and tried to find out measures that can increase financial development. This study tried to answer theoretically the first question related to what are the causes of underdevelopment in Pakistan. For the second question, this study not only suggested the openness hypothesis but also tested it empirically. The questions are vital as the World Bank has warned Pakistan of a volatile economic future with suppressed growth and weak financial markets. The above solution can be a way forward for Pakistan. The openness hypothesis introduced by Rajan & Zingales (2003) suggested that simultaneous opening of the capital account and trade account will reduce the resistance of elites. They are theorized to lose if financial development is improved and opening of one sector, either capital or trade account, will be resisted and will not bring any positive results alone.

However, results show mixed results, where for one proxy of financial development, the openness hypothesis is validated, and for the second proxy, we did not find support for the openness hypothesis. Among capital and trade accounts, capital accounts exert a positive impact on financial development, and trade openness is only weakly related to dependent variable. In this background, it seems capital account and trade account are not complements but rather substitutes. Our results also indicate that a capital account is more effective then trade openness so given one option Pakistan should open capital account. On the basis of our study, we suggest that Pakistan should improve their trade and capital account competitiveness before they can liberate it or open it.

For testing the openness hypothesis in the future, this study recommends using more proxies for financial development and advanced estimation techniques.

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