

# The Financial Liberalization and Domestic Savings in Economic Development (Case Study of Pakistan)

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## ABSTRACT:

*The study emphasis to investigate the “financial liberalization and domestic savings in economic development (Case study of Pakistan)”. This study using annual time series data during 1974-2012. This study employed Ordinary least squares method to check the results. In this study financial liberalization is using as dependent variable and deposit rate, exchange rate, foreign direct investment, Inflation rate, Trade openness, Workers remittances is used as independent variables. The foreign direct investment and deposit rate are the main variables and both showed the positive impact on financial liberalization. The empirical results of this study shows positive impact of financial liberalization on economic growth and also shows positive impact on domestic savings.*

**Keywords:** Financial Liberalization, Economic Development, Deposit Rate, Exchange Rate, Foreign Direct Investment, Inflation Rate, Trade Openness, Workers Remittances.

## 1. INTRODUCTION:

Pakistan's economy was not developing due to different problems after 1947. In first decades of Pakistan economic performance was very poor. The economic performance and many polices used to maintain GDP level at 5-6% with cyclical downturns of 1960. Pakistan was facing difficulties and the basic reason of difficulties was high expenditures on defense, high population, political instability and ignorance of social sector (education, health, entertainment etc.). After independence Pakistan couldn't gain high growth rates till first four decades due to political instability. Lawlessness, political instability and terrorism and created many economic and financial difficulties during 1990. To support economic development of Pakistan financial sector was essential element. Government used the structural adjustment programs (SAP) in the early 1990's in order to improve problems of Pakistan. To liberalize financial sector SAP introduced some reforms. The basic reforms was: public banking was transferred into nonpublic banking, foreign exchange system liberalized, equity markets more liberalized, foreign investors can easily inflows or outflows the investment, profit etc. The financial liberalization took place in 1990's was part of big move toward giving markets a great role in economic growth. Domestic savings consists on public and private savings. Domestic saving is a part of national savings and the total national savings of Pakistan was 83 percent during 1960-1990. Gross national product was lies between 6.6% to 10%. Financial liberalization was directed to decrease activities of agents in financial sector. Financial liberalization increased investment and also increased savings. “Financial liberalization is described as the freedom of finance in any country” “When a country gives permission to move money in and out freely it is called financial liberalization” “Domestic savings is described as avoidance of excess expenditures which enhanced of private resources for investment incensement” “Domestic savings is described as a source which people used to raise their standard of living”. The financial liberalization and domestic savings both played a vital role in the development of any country. The financial

liberalization is 40.00341 (World Development Indicator) in 2012 and the domestic saving is 7.064 (WORLD BANK) in 2012 in Pakistan.

### 1.1 Importance of the study:

McKinnon and Shaw (1973) showed that financial liberalization led to higher interest rates which equated the demand and supply of savings. The authors expressed their view that higher interest rates lead to increased savings and financial intermediation in improving the efficiency of savings and investment. The higher real interest rates increase the extent of financial intermediation which in turn raises the rate of economic growth in developing countries (Balassa, 1989)

Schumpeter (1911) argued that services provided by financial intermediaries are essential for economic development. Financial liberalization provides strength to financial markets and hence promotes economic growth (McKinnon, 1973 and Shaw, 1973).

High real interest rate (on bank deposits) stimulates financial and total domestic savings and then stimulates the private investment (Athukorala, 1998). The deregulation policy of interest rate promoted the savings and investment

Domestic savings had a very prominent role in order to sustain the growth of an economy because of increased external financial rigidity (Kasekende, et al. 1999). Financial liberalization gives information to reduce any type of rules on financial sector of a country.

- For stability of the monetary condition in a country financial liberalization is very important.
- Domestic savings plays a dominant role in economic development of a country.
- Domestic savings is important to help in different conditions like earth quake, etc because if people save money than their savings helped in any movement of their lifes.
- Financial liberalization and domestic savings both are the sources of economic development in any country

The scope of “Financial liberalization and domestic savings in economic development” touch the departments like Monetary, Macroeconomics, Political science, Globalization, Finance, International trade and many more other departments.

### 1.2 The Financial Liberalization ad Domestic Savings in Economic Development: Trends and Size

Trends are the most important part of all studies. The study presents the financial liberalization and domestic savings on economic development in Pakistan. Therefore, take the variables Deposit rate, Exchange rate, Foreign Direct Investment, Inflation Rate, Trade Openness and Workers Remittances for Financial Liberalization.

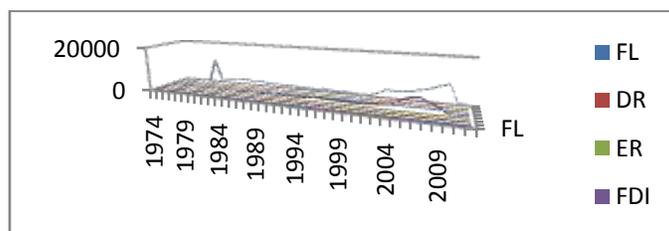


Figure 1. Trends and Size of Dependent and Independent Variables

Source: Author`s Calculation

The figure shows that in 1975 the financial liberalization was 33.66 but in 2012 it was 40.00 percent. The deposit rate was 2.74 percent per annum according to state bank of Pakistan. The exchange rate was 9.9 in 1974 and 93.39 in 2012. The Foreign direct investment was 14.9 million in 1974 and 1.3 in 2012. The inflation rate was 0.027 but 9.685 in 2012. The trade openness was 106.4 billion but it was 60.74 in 2012. The workers remittance was 139 but 1130.25 in 2012 according to state bank of Pakistan.

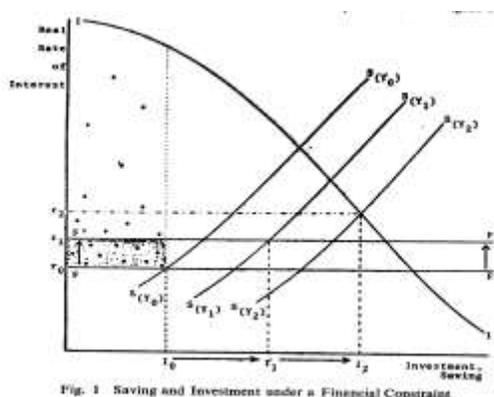
## 2. THEORETICAL FRAMEWORK

In this section the theory of McKinnon is used according to the topic of “financial liberalization and domestic savings in economic development”. The many few theories explained the importance of financial development but few agreeable frameworks was existing even the publications of McKinnon (19) and Shaw (25).

The Neoclassical theories showed the role of monetary process. McKinnon and Shaw gave its views. McKinnon produced model in which real money balances are used as element. Shaw rejects the Neoclassical growth models which are consist on financial intermediation.

### 2.1 McKinnon-Shaw Model of Financial liberalization

The basic factor of McKinnon-Shaw is Financial liberalization are shown as:



In this diagram Saving,  $S(Y_0)$ , at income level  $Y_0$  is a function of the real interest rate.  $F$  showed the financial constraint, which examined institutional nominal interest which takes the real rate below its equilibrium level. Raising the financial constraint the from  $F$  to  $F'$  showed that saving and investment both are increases. All low yield investment is showed by the shaded area. When the level of income are increased than the saving function shifts and reached on the point  $S(Y_1)$ . In the return to savers the real interest rate is used as major factor to promote it to higher level and also promote its efficiency. The policy showed to increase institutional interest rates and decrease the rate of inflation. When investments of efficiency achieved. It is shown in the figure by equilibrium level at  $I_2$ ,  $R_2$  higher income level at  $Y_2$ . So, it is clearly showed that the real interest rate help to making saving function.

The McKinnon state the hypothesis which is known as complementarily hypothesis. According to the McKinnon complimentarily hypothesis consists on two key assumptions: (i) all economic agents are restricted to self-finance; and (ii) due to indivisibilities, investment requires the prior accumulation of money balance.

Shaw gave its views about financial intermediation which resulted from financial liberalization, i-e higher real institutional interest rate, raises incentives and increases the capacity of investment. When financial intermediaries increase real returns to savers and at this time lower real costs to investors by accepting liquidity preference, decreasing risk, raising operational capacity and decreasing information costs to both savers and investors.

The empirical test showed in McKinnon and Shaw theory focused on a saving function with one described in:

$$\frac{Sd}{Y} = f\left(\frac{Y}{PN}, d, i^*, \frac{Sf}{Y}\right)$$

Sd is domestic saving. Y is gross domestic product. P is implicit gross national product deflator. N showed population. d is nominal rate of interest on 12 month time deposits.  $i^*$  is the expected rate of inflation. Sf showed foreign saving. The time deposit rate is used as a proxy for nominal rates of interest. The real is divided into components d and  $i^*$  and these components move in the same direction. That's why the problem of multicollinearity showed. The identification problem here was investigated by Modigliani (22). When the saving and investment estimated jointly in free market condition than the problem of identification is showed in the economy. Than interest rate set by the government order. These rates below their free market levels. This showed that investment increases the interest and on this stage if more investment showed at this rate and more funds i-e saving available.

This theory showed that the financial liberalization is a great source of domestic savings. If the financial repression are showed in economy of any country than the country couldn't achieve development. According to the theory of McKinnon-Shaw theory the financial repressions defined as indiscriminate: distortions of financial prices including interest rates and foreign exchange rates"- which reduce "the real rate of interest of growth and the real size of financial system relative to non-financial magnitudes" (25, p.3). Pakistan develops its financial sector after the existence of structural adjustment programs (SAP).

### 3. DATA & METHODOLOGY

#### 3.1 Data:

This chapter shows the sources of data used in the present study. The study used Annual time series data during the period 1974-2012. In this study obtained from World development indicator, State bank of Pakistan (hand book of statistics) and Economic survey.

#### 3.1 Table 1. Description of variables

Variables	Descriptive variables	Units of measurement	Sources	Signs
<b>Dependent variable</b>				
<b>FL</b>	<b>Financial Liberalization</b>	<b>M2 as % of GDP</b>	<b>World Development indicator</b>	
<b>Independent variables</b>				
<b>DR</b>	<b>Deposit Rate</b>	<b>Percent per annum</b>	<b>State Bank of Pakistan</b>	<b>Positive</b>
<b>ER</b>	<b>Exchange Rate</b>	<b>LCU per US dollar, period average</b>	<b>World Development Indicator</b>	<b>Positive</b>
<b>FDI</b>	<b>Foreign Direct Investment</b>	<b>Million Dollar</b>	<b>State Bank of Pakistan</b>	<b>Positive</b>
<b>INF</b>	<b>Inflation Rate</b>	<b>CPI</b>	<b>World Development</b>	<b>Negative</b>

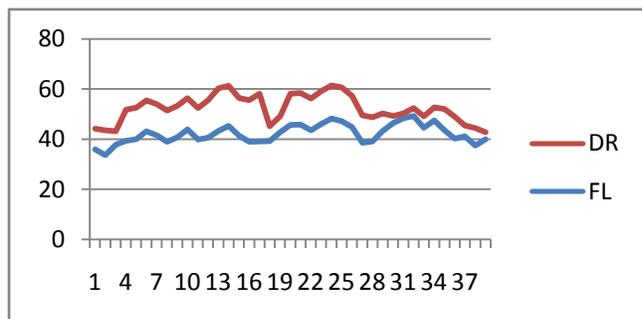
			<b>Indicator</b>	
<b>TO</b>	<b>Trade Openness</b>	<b>Billion</b>	<b>World Bank</b>	<b>Positive</b>
<b>WR</b>	<b>Workers Remittances</b>	<b>Million US dollar</b>	<b>State Bank of Pakistan</b>	<b>Positive</b>

### 3.1.1 Financial Liberalization:

Financial liberalization is defined as M2/GDP or M2 as percentage of GDP. Financial liberalization has positive effect on economic growth.

### 3.1.2 Deposit Rate

People are save more income and consume less quantity of income for the sake to receive more return on bank`s deposits with the increase in interest.



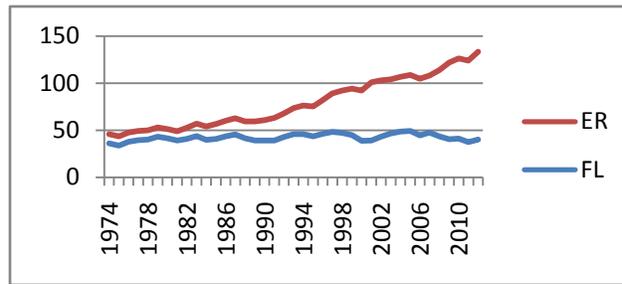
Source: Author`s Calculation

3.1.2 Figure 2. Financial Liberalization and Deposit Rate:

The figure shows positive relationship between financial liberalization and deposit rate. The financial liberalization is 39.85505 and the deposit rate is 12.57 in 1984. The financial liberalization is 45.31106 and the deposit rate is 15.92 in 1987 it clearly shows that when financial liberalization is low the deposit rate is also low and when financial liberalization increase the deposit rate also increase.

### 3.1.3 Exchange Rate

The change of one county`s currency in to another country`s currency.



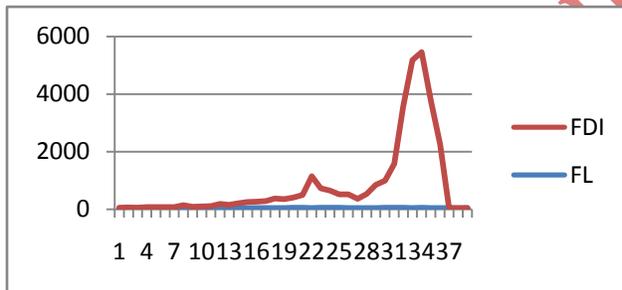
3.1.3 Figure 3. Financial Liberalization and Exchange Rate

Source: Author`s Calculation

The figure shows the impact of financial liberalization on exchange rate is positive. In 1990 the financial liberalization is 39.1371 and exchange rate is 21.70738 and in 1994 the financial liberalization is 45.75916 and exchange rate is 30.56659. This shows that when financial liberalization increase in any country the exchange rate is also increase.

### 3.1.4 Foreign Direct Investment:

FDI is a controlling authority in a business sector from one country to another country.



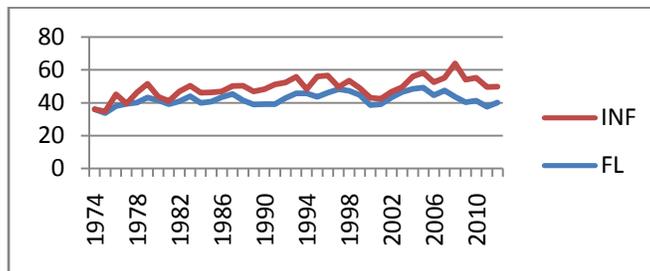
Source: Author`s Calculation

3.1.4 Figure 4. Financial Liberalization and Foreign Direct Investment

The figure shows that positive relations exist in financial liberalization and foreign direct investment. The financial liberalization is 35.90239 and the foreign direct investment is 14.9 in 1974. The financial liberalization is 40.03503 and foreign direct investment is 36.0 in 1978 it clearly shows that when financial liberalization is low the foreign direct investment is low and when financial liberalization increase the foreign direct investment is also increase.

### 3.1.5 Inflation Rate:

Inflation means rise in the prices. In Pakistan the problem of inflation is very prominent. It affected public and private economic planning. In this study consumer price index is used as the unit of measurement.



Source: Author`s Calculation

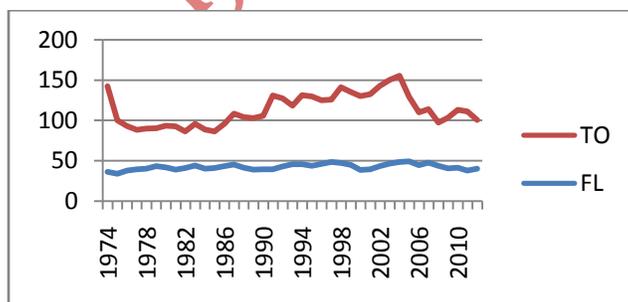
3.1.5 Figure5. Financial Liberalization and Inflation Rate

The figure shows negative relationship between financial liberalization and Inflation rate. In 1979 the financial liberalization is 43.11308 and inflation is 8.267. The financial liberalization is 39.1899 and inflation is 11.791 in 1991. This shows that when the financial liberalization decrease the inflation rate increase.

### 3.1.6 Trade Openness:

Trade openness may be defined as the ratio in percentage of the sum of imports of goods and services and exports of goods and services to GDP. It can be defined as

$$\text{Trade Openness} = (X+M)/\text{GDP}$$



Author`s Calculation

3.1.6 Figure 6. Financial Liberalization and Trade Openness

This figure shows positive relation between financial liberalization and trade openness. The financial liberalization 39.35625 in 1977 and trade openness is 48.81 but when financial liberalization increase as 43.25191 in 2002 the trade openness is also increase as 99.4 which shows positive relation in both variables.

### 3.1.7 Workers Remittances

The money of the people who are earning through abroad and sending money to their relative which lives in Pakistan is called worker remittances.

### 3.2 Methodology

The methodology applied to examine the “Financial liberalization and domestic savings in economic development case study of Pakistan”. This study used the Ordinary Least Square method.

#### 3.2.1 Ordinary Least Square Method

Carl Friedrich Gauss (1821), a mathematician and he presented ORDINARY LEAST SQUARE METHOD in 1974. OLS method is used to examine the association among variables. This method is applied when all the variables are stationary at level. When the variables are stationer at level ( the value of DURBAN WATSON greater than R-squared) it means that OLS is useful and applicable.

Multiple regression equation takes the form as:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \dots + \beta_n X_n + \mu$$

Where

Y= Dependent variable

X<sub>i</sub>= Set of explanatory variables.

μ = Disturbance term

#### 3.2.2 Model specification

Model specification is based on multiple regression technique. The model is specified with one dependent variable and seven independent variables are given below. Linear model is followed in present study. The model is:

$$FL = \beta_0 + \beta_1(DR) + \beta_2(ER) + \beta_3(FDI) + \beta_4(INF) + \beta_5(TO) + \beta_6(WR) + \varepsilon$$

Where FL= Dependent variable which is financial liberalization.

DR= deposit rate

ER=exchange rate

FDI=foreign direct investment

INF=inflation rate

TO=trade openness

WR=worker remittances

## 4. ANALYSIS & RESULTS:

### 4.1 Regression Analysis

This table is used for determined regression results. In first column independent variables are showed. The second column is coefficient this is helpful to give information about the impact of independent variables on dependent variable. The third column is standard error. The third and fourth column is t-test and probability

#### 4.1 Table 1. Regression Analysis

Dependent Variable: FL

Method: Least Squares

Sample: 1974 2012

Included observations: 39

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	32.79178	3.768174	8.702299	0.0000
DR	0.242373	0.159985	1.514975	0.1396
ER	0.003872	0.030472	0.127060	0.8997
FDI	0.001266	0.000466	2.718703	0.0105
INF	-0.072472	0.152864	-0.474098	0.6386
TO	0.073513	0.034678	2.119882	0.0419
WR	0.000405	0.000267	1.519089	0.1386
R-squared	0.351567	Mean dependent var		42.21205
Adjusted R-squared	0.229985	S.D. dependent var		3.671847
S.E. of regression	3.222063	Akaike info criterion		5.339069
Sum squared resid	332.2141	Schwarz criterion		5.637657
Log likelihood	-97.11185	Hannan-Quinn criter.		5.446200
F-statistic	2.891618	Durbin-Watson stat		0.902938
Prob(F-statistic)	0.022893			

Source: Author's Calculation (Eviews 7.0)

In this table Deposit rate showed the positive relationship with financial liberalization. The standard error of DR is 0.1599. DR is statistically insignificant. The Exchange rate showed positive impact and standard error is 0.03. The exchange rate is insignificant because the value of prob. is 0.15. The impact of foreign direct investment is positive. The standard error is 0.0004. FDI is statistically significant. The impact of Inflation rate is negative on financial liberalization. The standard error of inflation is -0.09. Inflation is insignificant. Positive impact of Trade Openness and standard error is 0.04. Trade openness is statistically significant. The table showed positive impact of Workers Remittances. The standard error of WR is 0.0002. Workers' Remittances is insignificant. The value of Durbin-Watson is 0.90 and the value of R-squared is 0.35.

### 4.2 Descriptive Analysis

Descriptive Analysis shows advantages of the data like Arithmetic Mean, Median, Standard deviation, Skewness, Kurtosis, Maximum and Minimum values of data series. It also defined the degree of relationship among variables.

**4.2 Table 2. Descriptive statistics**

	Mean	Maxi.	Std.Dev	Skewness	Kurtosis	Jorque-Bera	Prob.
FL	42.212	49.186	3.6718	0.0015	2.3815	0.6215	0.7328
DR	10.237	18.890	4.3970	-0.2596	2.1439	1.6292	0.4428
ER	36.622	93.395	25.840	0.6350	2.1471	3.8033	0.1431
FDI	778.80	5410.2	1362.8	2.3597	7.5395	69.681	0.0000
INF	6.8616	20.286	4.3342	0.6744	3.7078	3.7713	0.1517
TO	71.077	107.06	18.597	0.3696	1.9599	2.6460	0.2663
WR	2676.0	11397.9	2431.9	1.9276	6.5369	44.481	0.0000

Source: Author's Calculation (Eviews 7.0)

Average value of FL is 42.212. The maximum value of FL is 49.18. The standard deviation is 3.67. The skewness of FL is positive. The FL kurtosis is meso kurtic. The results of Jarque-Bera are 0.62. The FL is normally distributed. The mean of Deposit rate is 10.23. The values of maximum and standard deviation are respectively 18.89 and 4.39. Deposit rate is negative skewed and its value is -0.25. The value 2.14 showed that the deposit rate is meso kurtic. The value of Jarque-Bera is 1.62. The value of prob. is 0.44 which showed DR is normally distributed. The 36.62 is the mean of Exchange rate. Their maximum value is 93.39 and std.dev is 25.84. The value of skewness showed the positivity of exchange rate and 2.15 showed that ER is meso kurtic. The value of prob. is 0.14 which shows that ER is normally distributed. The mean of Foreign Direct Investment is 778.80. The FDI values of maximum and standard deviation is 5410.2, and 1362.81. The value of skewness is 2.35 and the value of kurtosis is 7.53 which show that FDI is positive skewed and leptokurtic. The value of its Jarque-Bera is 69.68 and FDI is not normally distributed because its value is 0.000. The mean, maximum and standard deviation values of Inflation rate is respectively 6.86, 20.28, and 4.33. The INF is positive skewed at the value 0.67. The value of kurtosis shows that INF is leptokurtic. The Jarque-Bera value is 3.77. The value of prob. showed INF is normally distributed. Average value of Trade openness is 71.07. The maximum value of TO is 107.06. The standard deviation is 18.59. The skewness of TO is positive. The TO kurtosis is platykurtic. The result of Jarque-Bera is 2.64. The TO is normally distributed. The mean of Workers Remittances is 2676.0. The WR values of maximum and standard deviation is 11397.9 and 2431.9. The value of skewness is 1.92 and the value of kurtosis is 6.53 which show that WR is positive skewed and leptokurtic. The value of its Jarque-Bera is 44.48 and WR is not normally distributed because its value is 0.000.

**4.3 Correlation Matrix**

Correlation matrix describes association among two or more variables. Correlation is also used to find out degree and strength of association among variables.

**4.3 Table 3. Correlation Matrix**

	FL	DR	ER	FDI	INF	TO	WR
FL	1.0000						
DR	-0.1210	1.0000					
ER	0.25258	-0.6088	1.0000				
FDI	0.4631	-0.4298	0.4558	1.0000			
INF	0.1125	-0.2315	0.5660	0.3473	1.0000		
TO	0.2564	-0.3967	0.3765	0.0695	-0.1043	1.0000	
WR	0.2848	-0.2418	0.3271	0.4085	0.5667	-0.1962	1.0000

Source: Author's Calculation (Eviews 7.0)

The table shows deposit rate is weekly correlated with financial liberalization. Exchange rate is weekly correlated with financial liberalization but moderately related with deposit rate. Foreign direct investment is weekly correlated with financial liberalization, deposit rate and exchange rate. Inflation rate is weekly related with financial liberalization, deposit rate and foreign direct investment but moderately related with exchange rate. Trade openness is weekly correlated with financial liberalization, deposit rate, exchange rate, foreign direct investment and inflation rate. Workers remittances is moderately correlated with inflation and weekly related with financial liberalization, deposit rate, exchange rate and foreign direct investment.

## 5. CONCLUSION

The empirical results of study showed in the early decades the financial liberalization doesn't exist in better position in Pakistan but now the financial liberalization showed the positive effect on economic growth. Financial liberalization also pays positive impact on domestic savings. Financial liberalization promotes more savings and by this the finance provided for investment. Financial liberalization improved banking institutions. This study showed positive impacts of deposit rate, exchange rate, foreign direct investment, trade openness, and workers remittances on financial liberalization. This study also showed negative impact on inflation rate. The empirical results also showed the financial liberalization and domestic savings both is used in economic growth of Pakistan but financial liberalization is the main factor of economic growth.

## 6. SUGGESTIONS

The suggestions are given below:

1-To support the liberalization process, the monetary authorities should create and maintain a stable macro-financial environment based on stable macroeconomic policies, low inflation and flexible interest rates.

2-Saving must be invested effectively to improve economic development and achieve maximum welfare of the society

3-There is a need to control inflation to provide favorable environment.

4-Another important point is that the Government should provide enabling environment and fiscal incentives for enhancing the foreign direct investment. This will increase the savings in the country.

5-The government should ensure that the business climate is conducive for investments to thrive. This can be done by establishing an incentive framework and a business climate supportive of entrepreneurship and private sector development. When this is done, economic growth will be enhanced.

6-The government should avoid depreciation in the value of the nation's currency and also maintain stability in the exchange rate.

7-The stability of the economy should first be taken into consideration before implementing financial liberalization measures. Strong macroeconomic policies should be pursued to maintain and stabilize the economy.

8-The regulatory and supervisory framework for the financial sector should be strengthened. One way to achieve this is by laying down strict prudential rules and regulations to stabilize and strengthen the banking industry.

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