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STABILITY OF MONEY DEMAND IN PAKISTAN: THE IMPACT OF EXCHANGE RATE, REMITTANCES, AND FINANCIAL LIBERALIZATION

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DOCTOR OF PHILOSOPHY
UNIVERSITI OF UTARA MALAYSIA
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STABILITY OF MONEY DEMAND IN PAKISTAN: THE IMPACT OF EXCHANGE RATE, REMITTANCES, AND FINANCIAL LIBERALIZATION

By

NIAZ HUSSAIN GHUMRO

Thesis Submitted to
Othman Yeop Abdullah Graduate School of Business, Universiti Utara Malaysia,
In Fulfilment of the Requirement for the Degree of Doctor of Philosophy
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ABSTRACT

Understanding the demand for money in an economy is an important prerequisite for formulating and conducting monetary policy. Several macroeconomic variables influence the money demand. Pakistan has undergone significant changes in the macroeconomic landscape over the years such as exchange rate changes with its volatility, remittances, and financial liberalization. Such changes in the economy might have caused shifts in the parameters of the money demand function over time, making the function unreliable for policy decisions. It is therefore necessary to investigate money demand function in the Pakistan, including exchange rate with its volatility, remittances, and financial liberalization in order to capture their long-run and short-run effects. Using Autoregressive Distributed Lag (ARDL) Bounds Testing Approach, this study sought to examine the relationship between demand for money and exchange rate with its volatility, remittances and the pace of financial liberalization in Pakistan using data from 1972 to 2014. Empirical results of the study reveal that exchange rate and its volatility support the wealth effect hypothesis, and uncertainty in the exchange rate drives more holding of the domestic currency. The positive and inelastic coefficient of remittances show the increasing patterns of consumption among the households and revealing inefficiency of regular channels of remittances in Pakistan. Financial liberalization increases money demand and its small coefficient reveals that the pace of financial liberalization is still growing. Finally, this thesis examines the stability of both models for policy implementation. The results reveal that only model for real narrow money demand is stable. Thus, the policy makers should consider real narrow money demand as a policy tool in Pakistan.

Keywords: money demand, volatility, remittances, financial liberalization, ARDL

Kata Kunci: permintaan wang, volatility, kiriman wang, liberalisasi kewangan, ARDL
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TABLE OF CONTENTS

TITLE PAGE ii
CERTIFICATION OF THESIS iii
PERMISSION TO USE v
ABSTRACT vi
ABSTRAK vii
ACKNOWLEDGEMENT viii
TABLE OF CONTENTS x
LIST OF TABLES xiii
LIST OF FIGURES xiv
LIST OF ABBREVIATION xv

CHAPTER ONE INTRODUCTION

1.1 Introduction 1
1.2 Background of the Study 1
1.3 Problem Statement 14
1.4 Research Questions 19
1.5 Research Objectives 20
1.6 The Scope of the Study 20
1.7 Significance of the Study 21
1.8 Overview of Money Supply, Exchange Rate and Remittances in Pakistan
   1.8.1 Money Supply 22
   1.8.2 Exchange Rate 26
   1.8.3 Remittances 31
1.9 Summary and Organization of Study 38

CHAPTER TWO LITERATURE REVIEW

2.1 Introduction 39
2.2 Money Demand Theory 39
   2.2.1 Quantity Theory of Money 41
       2.2.1.1 Fisher’s Equation of Exchange 42
       2.2.1.2 Cambridge Cash Balanced Approach 43
   2.2.2 Neo Classical Approach 45
       2.2.2.1 Keynesian Theory 46
       2.2.2.2 Post Keynesian Theories
           i Inventory Theoretic Approach 47
           ii Precautionary Demand for Money Approach 48
           iii Other Models 49
   2.2.3 Money as an Assets Approach 50
   2.2.4 Consumer Demand Theory 52
CHAPTER FOUR RESULTS AND DISCUSSION

4.1  Introduction .......................... 150
4.2  Empirical Results ...................... 150
4.3  Descriptive Statistics .................. 151
4.4  Correlational Matrix ................... 153
4.5  Stationarity of Variables .............. 155
4.6  Bounds Test Results ................. 158
4.7  Battery of Diagnostics Tests Results 176
4.8  Stability of Parameters .............. 179
4.9  Discussion of Results ............... 182
4.10 Summary of Chapter ................. 189

CHAPTER FIVE SUMMARY OF MAJOR FINDINGS,
POLICY IMPLICATIONS, AND CONCLUSION

5.1  Introduction… .......................... 191
5.2  Summary of Results .................... 191
5.3  Summary of Major Findings .......... 197
5.4  Policy Implications .................... 199
5.5  Conclusions ........................... 202
5.6  Limitations of the Study ............. 203
5.7  Suggestions for Future Research .... 204

REFERENCES ................................ 205
LIST OF TABLES

Table 1.1: Comparison between Remittances of Pakistan in year 2011 & 2014 36
Table 4.1: Estimation Results of Descriptive Statistics using all the quantitative variables in the model 152
Table 4.2: Estimation Results of Correlation Matrix Using all the quantitative Exogenous Variables 154
Table 4.3: Stationary Results of ADF, PP, and KPSS Test Statistics for the Data from 1972-2014 157
Table 4.4: Bounds Test Results for Long Run Relationship in Basic Models of LNM1 and LNM2 160
Table 4.5: The long-run Elasticites Using the ARDL Approach for LNM1 and (LNM2). 166
Table 4.6: The Short-run Elasticites Using the ARDL Approach for ΔLNM1 and ΔLNM2 172
Table 4.7: Estimation Results of Battery of Diagnostics for LNM1 and LNM2 Models 177
Table 4.8: Summary of Results Estimation in Terms of the Signs and Significance of the Variables in the Models of LNM1 and LNM2 183
<table>
<thead>
<tr>
<th>Figure</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.1</td>
<td>Graph of the M1, M2, Remittances and Exchange Rate from 2000 to 2013.</td>
<td>15</td>
</tr>
<tr>
<td>1.2</td>
<td>Trends of M1 and M2 from 2000-2001 to 2013-2014</td>
<td>25</td>
</tr>
<tr>
<td>1.3</td>
<td>Pak rupee Depreciation versus US Dollar from 1982 to 1992</td>
<td>29</td>
</tr>
<tr>
<td>1.4</td>
<td>Exchange Rate Trends in Pakistan versus USD</td>
<td>31</td>
</tr>
<tr>
<td>1.5</td>
<td>Trend of Remittances post 9/11 in Pakistan</td>
<td>37</td>
</tr>
<tr>
<td>3.1</td>
<td>Framework of the Study</td>
<td>119</td>
</tr>
<tr>
<td>4.1</td>
<td>Graph of Top Twenty Models Through Hannan Quinn Criterion for LNM1</td>
<td>163</td>
</tr>
<tr>
<td>4.2</td>
<td>Graph of Top Twenty Models Through Hannan Quinn Criterion for LNM2</td>
<td>164</td>
</tr>
<tr>
<td>4.3(a)</td>
<td>Graph of CUSUM Test for LNM1</td>
<td>180</td>
</tr>
<tr>
<td>4.3(b)</td>
<td>Graph of CUSUMQ Test for LNM1</td>
<td>180</td>
</tr>
<tr>
<td>4.4(a)</td>
<td>Graph of CUSUM Test for LNM2</td>
<td>181</td>
</tr>
<tr>
<td>4.4(b)</td>
<td>Graph of CUSUMQ Test for LNM2</td>
<td>181</td>
</tr>
</tbody>
</table>
## LIST OF ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADB</td>
<td>Asian Development Bank</td>
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<tr>
<td>AIC</td>
<td>Akaike Information Criterion</td>
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<tr>
<td>ARDL</td>
<td>Auto-regressive Distributed lag</td>
</tr>
<tr>
<td>ASEAN</td>
<td>Association of South Asian Nations</td>
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<tr>
<td>BOE</td>
<td>Bank of England</td>
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<td>BSC</td>
<td>Bayesian Schwartz Criterion</td>
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<td>ECB</td>
<td>European Central Bank</td>
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<td>EG</td>
<td>Engle Granger</td>
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<td>EU</td>
<td>European Union</td>
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<td>Fed</td>
<td>Federal Reserve Board</td>
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<td>FSRs</td>
<td>Financial Structural Reforms</td>
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<tr>
<td>FY</td>
<td>Fiscal Year</td>
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<td>GCC</td>
<td>Gulf Cooperation Council</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<tr>
<td>GNP</td>
<td>Gross National Product</td>
</tr>
<tr>
<td>HQC</td>
<td>Hannan Quinn Criterion</td>
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<tr>
<td>IADB</td>
<td>Inter-American Development Bank</td>
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<tr>
<td>IFS</td>
<td>International financial statistics</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>JJ</td>
<td>Johansen Julius</td>
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<tr>
<td>KSA</td>
<td>Kingdom of Saudi Arabia</td>
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<tr>
<td>LDCs</td>
<td>Less Developed Countries</td>
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<td>LN</td>
<td>Natural Logarithm</td>
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<td>Abbreviation</td>
<td>Full Form</td>
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<tr>
<td>Log</td>
<td>Logarithm</td>
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<tr>
<td>PAD</td>
<td>Partial Adjustment Dynamic</td>
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<td>PKR</td>
<td>Pak Rupee</td>
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<tr>
<td>SAP</td>
<td>Structural Adjustment Program</td>
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<td>SBP</td>
<td>State Bank of Pakistan</td>
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<tr>
<td>UAE</td>
<td>United Arab Emirates</td>
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<td>UK</td>
<td>United Kingdom</td>
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<td>US</td>
<td>United States</td>
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<tr>
<td>USA</td>
<td>United States of America</td>
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<tr>
<td>USD</td>
<td>United States Dollar</td>
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<tr>
<td>VAR</td>
<td>Vector Auto-regressive</td>
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<td>WDI</td>
<td>World Data Indicator</td>
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CHAPTER ONE

INTRODUCTION

1.1 Introduction

The function for money demand has long been a fundamental block in macroeconomic modelling and remained an important framework for monetary policy in the economy. This chapter presents background of the study, problem statement, research questions, research objectives, scope of the study, and significance of the study. Further, it discusses historical review of money supply, exchange rate, and remittances in the context of Pakistan, ending the chapter with summary and organization of the study.

1.2 Background of the Study

Money demand is considered as heart of the monetary policy in the field of monetary-economics. It can be defined as the amount of cash balances desired to hold in one’s pockets. Money demand can be further divided into combination of liquid and semi-liquid assets that can be easily used as medium of exchange. It guides the policy makers in devising optimal monetary policy for the economy. Because of its importance, many studies have been conducted in both developed and developing economies in the past. There are basically two issues related to money demand world-wide. First, money demand should be in coordination with the announced objectives of monetary policy of an economy. Second, irrespective of the size of the economy, there should be specific form of money demand function which plays key role in the whole economy.
The contents of the thesis is for internal user only
In the presence of given limitations, we suggest that researchers should focus on highlighted issues. First, future studies should use rich datasets by expanding their coverage with higher frequencies to include other countries with Pakistan. Second, other potential determinants of money demand can be included by analyzing their effects on money demand this would enlarge the datasets including other countries. This study only examines the effects of volatility of exchange rate on money demand but it did not consider the volatility of interest rates domestic as well as foreign, and prices as determinants of money demand. Therefore, future research should consider interest rates volatility and price volatility to see how they affect money demand and its stability.

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economies resemble industrial countries or other developing countries?

*Economic Modelling*, 27(6), 1514-1521.


