The Impact of Financial Sector Development on the Sustainable Economic Growth of Pakistan

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**ABSTRACT**

**Purpose:** The study examines the impact of financial institutions and market development on the sustainable economic growth of Pakistan.

**Design/Methodology/Approach:** The time series data of Pakistan is analyzed from 1985 to 2022 by using the OLS with lags approaching.

**Findings:** Financial institutions development particularly banks are playing a positive role in the real GDP growth rate of Pakistan. Financial openness has a neutral effect, intermediation and liquidity have a positive effect and financial institution expansion harms the real GDP. The financial market development is playing a negative role in the real GDP growth rate in Pakistan due to weak, fragile, and inefficient financial markets.

**Implications/Originality/Value:** Our study findings suggest that for sustainable economic growth Government should encourage and support financial institutions particularly banks to increase economic activities in the country.


**Introduction**

According to the World Bank, the financial sector comprises markets, institutions and markets, a set of financial instruments, and supervisory institutions responsible for the execution of transactions. If financial institutions are not operating properly, the economy will not run smoothly, which will eventually result in financial crises and affect the economic growth of the...
countries. The financial sector plays a prominent role in economic performance and economic development. The pioneer study to trace out the association of the financial sector role particularly banking system for economic development by Schumpeter. The concept of “Economic Development” is broader than comparatively of economic growth. Reversely, economic growth is conditioned by the economic development. Economic development can be only achieved through GDP growth. Contrarily, sustainable economic development can be achieved through economic growth. The key sources of GDP growth are technology, capital, and labor. Economic growth is defined as an “increase in the productivity capacities of the country” (Rais & Anwar, 2012). GDP is measured by comparing the current year's GDP with the previous year's. The advanced and developed countries have well-functioning financial sector; which ultimately provides high economic growth comparatively in developing countries. The financial sector of emerging economies is not well-equipped and undeveloped. Therefore, developing countries have low economic growth (World Bank). According to the World Bank, the financial sector is divided into two categories financial markets and Financial Institutions.

Financial Markets
The market in which financial instruments including debt and equity securities are traded and exchanged. The key function is to facilitate the investors and lenders through the flow of funds from surplus and deficit units. Corporations, individuals, and firms finance their investments. Additionally, Wurgler (2000) differentiates between the allocations of capital through the financial markets of developed countries and developing countries. The faster capital allocation by financial markets of developed countries is compared to developing countries. It enhances the investment ultimately leads industrial growth by reducing the contracts. Furthermore, Levine (2004) states that the markets of countries grow faster and develop competition; where the financial markets are functioning properly and smoothly. Financial market development is prominent in every country in context of the economic growth. It plays an optimistic role in the allocation of capital. Hence, financial markets are considered the backbone of the country in building up the economy by channeling funds to the private sector and the Government. The countries that have stable financial markets are enjoying rapid growth compared to countries that have fragile financial markets.

Financial Institutions
The key function of the financial institutions is to intermediate the borrower and lender. Precisely, the smooth flow of the funds from savers to investors. The banking sector is being regulated by the Central Bank of the country contrary, the Non-banking firms are being regulated by SEC (Securities Exchange Commission) of the country particularly insurance companies.

According to the World Bank, there are five functions of financial institutions;

- Provide prior information about investment and capital allocation
- Monitor investment and corporate governance after financing
- Smooth flow of funds from surplus units to deficit units
- Ease for exchange of goods and services
- Facilitate the trading, diversification, and risk management

If there is a disruption in the smooth aforementioned functions of financial institutions ultimately leads to financial crises. Additionally, Javaid et al., (2016), the sound infrastructure of the financial system plays a prominent role in the higher policy performance for Macroeconomic indicators and monetary policy execution at the national level. According to Khulaifi and Sulaiti (1999), the economic growth of the nation varies from one country to another country due to the soundness of the financial market development. The difference is due to central banking policies for scheduled banks and the economic environment of these countries.
Financial Sector Development and Economic Growth

The growth of the economy and financial development have a strong association. The one of factors contributing to economic growth is “Financial Development”. The indicator for economic development is economic growth (Khan et al., 2015). According to Cristina, Yan, and Zhang (2019), the economic view of the contribution of financial institution development on economic growth in many ways. E-g the financial institutions have fixed costs to easily collect information of the project and evaluate information on these projects. Therefore, financial institutions identify the successful project compared to individuals. Additionally, the financial institutions monitor the project activities of the managers and ensure efficient and effective use of the saver's financial resources.

Moreover, Levine's (1997) empirical evidence and theoretically a positive relationship exists between financial development and economic growth. In addition, David (2006), identifies three functions of financial institutions and markets. Firstly, “intermediation” is the channeling of the funds from the savers to large project investments. Secondly, “risk mitigation” facilitates the project and industries to hedge against risk. Thirdly “liquidity risk” the liquidity is maintained in the form existence of secondary financial markets where investors can easily buy or sell their shares without taking funds invested in the project. Initially, the developed financial institutions and markets ultimately lead to economic growth by channeling the funds from the savers to large project investments, reducing the risk and ensuring efficient and effective use of the saver's financial resources. Contrary, Erdal, Veli, and Tuzel's (2007) study named “event studies” the study concentrated on the events; that cause the development of financial markets and changes in their size in a short span of time to segregate the role of financial development from growth over time to time.

Contrary views about the role of the financial markets development on economic growth. The financial economists Odedokun (1996), Fink, Haiss, and Mantler (2005), and Beck (2008) state that the channeling of the funds from the savers to large project investments, reducing the risk and ensures efficient and effective use of the saver's financial resources. Thus, a high return on investment increases economic growth. On the other hand, Koivu (2002), Mehl, Vespro, and Winkler (2005), and Zang and Kim (2007) state no relationship between financial development and economic growth. Therefore, this study will examine the role of financial sector development and economic growth of Pakistan.

Research Gap

The existing literature has worked on the financial development of institutions by using an in-depth measurement approach to financial institution development. Rahman et al., (2020), Point out policy review for policymakers in the financial markets context to contribute positively to economic growth. Further steps towards financial liberation can enhance economic growth. The financial sector provides the capital to the firms for investment; eventually, it contributes to economic growth. Therefore, financial markets and institutions are an integral part of economic development (Gulzar, 2018). Likely, Malik and Shabbir (2018), the fluctuations of the economy are explained through the development of financial markets and institutions. Therefore, it plays a prominent role in the economy. Likewise, khan, Qayyum, and Sheikh (2005) concluded with a long-run stable relationship between financial depth and economic growth. Similarly, Khan and Arif (2009), studied impact of the financial development on human capital development on time series data from 1991 to 2016.

According to Lucas (1988), the financial sector has been given so much priority in the context of economic development. Moreover, Levine's (1997) empirical evidence and theoretically a positive relationship exists between financial development and economic growth. Firstly, “intermediation” is the channeling of the funds from the savers to large project investments.
Secondly, “risk mitigation” facilitates the project and industries to hedge against risk. According to endogenous growth theory, better financial services can be attained through financial development; ultimately boosting capital accumulation. Thus, financial development positively affects economic growth. In addition, strong linkage between the financial market development and economic growth of higher-income countries about competitiveness (Romer, 1990, Odhiambo 2004 & Alomari et al., 2019).

Most of the research has been done on financial market development and its impact on economic growth in Pakistan. Contrary, the present study examines the impact of financial sector development including financial markets development and financial institutions development on sustainable economic growth particularly in Pakistan. Moreover, research has been conducted on the topic with the latest time series data.

**Literature Review**

Most of the researchers have highlighted finance as an important component of economic growth including Lucas (1998), who ponders financial development as a small factor of economic growth. In addition, Schumpeter (1934), thinks the banking sector plays playing key role in the economic growth of the countries by funding efficient and productive investment. Jayaratne and Strahan (1996) address the causality problem and found the positive impact of financial development on entrepreneurship, access to credit for small firms, and economic growth. According to Levine (2005), financial markets and financial intermediaries play a positive role in economic growth. Likewise, Valeriu et al., (2019) used panel data to evaluate the development of financial sector performance on economic growth by applying panel regression. They came up with the result that financial development plays a positive role in economic growth. Moreover, Anwer et al., (2011), found a positive impact of financial development on economic growth in both the short run as well in long run. Causality tests showed that financial development is base for the economic growth of these countries. Contrary, to Panizza (2014), the relationship is deriving due to reverse causality.

The distribution of the capital can be accelerated through financial intermediaries. Ultimately, it increases the economic efficiency and efficiency within the corporate and government, leading towards economic growth. According to King and Levine (1993), traces out that financial development plays a positive role in the GDP per capita growth by using the size valuation of banks and monetary indicators. Similarly, Calderon and Liu (2003) recommend that the contribution of financial development to economic growth is higher in developing countries compared to developed countries. Likely, Masten et al., (2008) found similar findings of Calderon and Liu that developing countries are gaining more from financial development compared to developed countries in context of the economic growth by using European Panel data. Likewise, Rioja and Valev (2004) concluded that the countries have intermediate financial development. So, it plays a positive role in the economic growth of the countries.

The empirical study of 1997-1998 and 2007-2008 post-financial crises doubtful by concluding that financial development is a key component of sustainable economic growth. Contrary, Arestis and Demetriades (1997), Rousseau and Wachtel (2002), and Demetriades and Law (2006) find that financial development has no significant impact on economic growth. On the other hand, Gregorio and Guidotti (1995) used panel data from countries in Latin America. They found that negative relationship between financial development and economic growth. For instance, Swamy and Dharani (2020) found out non-linear relationship between financial development and economic growth due to an inverted U-shape. This is due to the desire to have a large financial sector (Benczur et al., 2019). According to Mahmood (2009), the study research findings show that the real deposit rate has a positive impact in the long run but is insignificant statistically. The real interest rate has lower responses comparatively to financial development to economic
growth. It implies that the delivery of funds is prominent comparatively to its interest cost. Rahman et al., (2020), Point out policy review for policymakers in the financial markets context to contribute positively to economic growth. Further steps towards financial liberation can enhance economic growth. Gross fixed capital formation has a statistically significant impact on economic growth. Otherwise, labor retard the economic growth of the Pakistan. Moreover, Khan et al., (2005), Tahir (2008), Jalil and Ma (2008), Mahmood (2013), and Naveed and Mahmood (2019) find out the relationship between financial development and economic growth by using a linear approach. Conclusively, the estimation became defunct due to financial sector structural changes; which had been initiated in Pakistan in 1990.

Likely, Benczur et al., (2019) found the relationship between financial development and economic growth by using a nonlinear approach due to financial sector structural changes; which had been initiated in Pakistan in 1990. To capture the non-linearities, so MSMS (Markov Switching) Model estimation technique has been used for the association of financial development and economic growth. Therefore, the present study examines the impact of financial sector development including financial markets development and financial institutions development on sustainable economic growth of Pakistan.

The numerous empirical studies from Levine (1993, 1997), Khan and Senhadji (2000), Abu Bader and Abu Qarn (2008), Samargandi et al., (2014), and Shahbaz et al., (2017) find out a positive association between economic growth and financial sector development in both developing countries and developed countries. The key reason for the positive is the liberalization of the financial markets. Financial liberalization increases economic activity and improves economic growth. The policies shift the structural changes to improve the efficiency of the economy. The relationship between financial development and economic growth by using a nonlinear approach due to financial sector structural changes. So, the MSMS (Markov Switching) Model is used for estimation. Therefore, the present study will check the relationship between the financial sector and the economic growth of Pakistan.

**Theoretical Framework**
The theoretical framework has been used from Global Financial Development, 2013 (World Bank). The financial sector is divided into two categories, Financial Markets and Financial Institutions. Furthermore, the World Bank has developed four measurement approaches for financial sector development including depth, stability, efficiency, and access. As data limitation, only a depth measurement approach for financial sector development (Financial markets and Financial Institutions) has been adopted. Therefore, the variables of depth are used for the research.

**Conceptual Framework**
The conceptual framework has been divided into two categories of financial sector development Financial Markets Development and Financial Institutions Development.
Financial Institutions Development

- PSCY
- BDY
- BAY
- MY
- FDIY
- WRY

RYGR

Financial Markets Development

- STY
- ST
- MCY

RYGR

Empirical Models

Financial Institutions Development

\[
\text{RYGR}_{it} = \beta_0 + \beta_1 \text{PSCY} + \beta_2 \text{BAY} + \beta_3 \text{BDY} + \beta_4 \text{MY} + \beta_5 \text{FDIY} + \beta_6 \text{WRY} + \epsilon_t \quad \ldots \quad EQ1
\]

Financial Markets Development

\[
\text{RYGR}_{it} = \beta_0 + \beta_1 \text{STY} + \beta_2 \text{ST} + \beta_3 \text{CY} + \epsilon_t \quad \ldots \quad \ldots \quad EQ2
\]

RYGR = Real GDP Growth Rate proxy variables for economic growth.
PSCY = Private sector credit to GDP
BDY = Banking deposit to GDP ratio proxy variables for financial intermediation.
BAY = Bank assets to GDP ratio proxy variables for expansion of the banking sector.
MY = M2 to GDP proxy variables for liquidity in the economy.
FDIY = Foreign direct investment TO GDP
WRY = Worker remittance TO GDP are proxy variables for Financial openness
STY = Stock traded to GDP
ST = Stock Turnover Ratio
CY = Market Capitalization to GDP

Justification of Variables

Real GDP Growth Rate is a proxy variable for economic growth (Adnan, 2009). The banking development can be determined by financial openness and trade (Baltagi et al., 2007). The proxy variables of financial intermediation indicate credit to the private sector and bank deposits (King and Levine, 1993); and have a positive impact by lending out to investors. While a Bank’s Assets to GDP ratio indicates the expansion of the financial institution (Levine 1996; Rioja and Velve, 2002). The proxy variables of liquidity in the economy (M2 to GDP) due to financial institutions and the proxy variables of financial openness are FDI and worker remittance (Beckaert et al., 2005); both FDI and workers’ remittance have a neutral impact on economic growth. The proxy variables such as the Stock turnover ratio indicate that the stock market of Pakistan, the size of
the stock market can be measured through the Market Capitalization to GDP ratio, and the stock traded to GDP ratio shows activity in the stock market. (Adnan, 2009).

Data Collection
Data to analyze this relationship is collected from secondary sources data, like as the State Bank of Pakistan, the Pakistan Stock Exchange, and the World Bank, and time series data is analyzed from 1985 to 2022 for both financial institutions and financial markets.

Estimation Techniques
Firstly, non-stationary or stationary variables are tested through Unit root through the Augmented Dickey-Fuller test. Ordinary least Square is employed when variables are stationary on the level and at first difference. Taking differentiation of the stationary variables at first difference. The differentiation is denoted by “D” and placed before the abbreviation of variable in OLS. The validity of the model can be checked from; Ramsey RESET checks model misspecification. LM statistic is used for serial correlation or autocorrelation. The normal distribution of the residual is checked through Jarque Bera. CUSUM checks the stability of the parameters.

Result and Discussion
Augmented Dickey-Fuller test
ADF test results are; The Real GDP Growth Rate (RYGR), MY, STY, and FDIY are stationary at level while, WRY, BAY, BDY, PSCY, ST, and MCY are stationary at first difference. Contrary, no variable is stationary at 2nd difference.

Table: 1. Unit Root Test Results

<table>
<thead>
<tr>
<th>Name of variables</th>
<th>Augmented Dickey-Fuller</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>I (0)</td>
</tr>
<tr>
<td>RYGR</td>
<td>-5.475*</td>
</tr>
<tr>
<td>MY</td>
<td>-5.080*</td>
</tr>
<tr>
<td>FDIY</td>
<td>-2.718***</td>
</tr>
<tr>
<td>WR</td>
<td>-4.5666*</td>
</tr>
<tr>
<td>BAY</td>
<td>-5.424*</td>
</tr>
<tr>
<td>BDY</td>
<td>-4.967*</td>
</tr>
<tr>
<td>PSCY</td>
<td>-5.018*</td>
</tr>
<tr>
<td>ST</td>
<td>-2.36*</td>
</tr>
<tr>
<td>CY</td>
<td>-7.85*</td>
</tr>
<tr>
<td>STY</td>
<td>2.937*</td>
</tr>
</tbody>
</table>

*** *** * indicates significance level at 10%, 5% and 1%

Diagnostic Tests
The following diagnostic tests are employed to check whether our model is error-free.

Table: 2. Diagnostic Tests Results

<table>
<thead>
<tr>
<th>Diagnostic Tests</th>
<th>Financial Institution</th>
<th>Financial Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ramsey RESET</td>
<td>0.2146 (0.8083)</td>
<td>0.688802 (0.5102)</td>
</tr>
<tr>
<td>F statistics</td>
<td></td>
<td></td>
</tr>
<tr>
<td>LM Test</td>
<td>0.939 (0.4038)</td>
<td>1.769 (0.188)</td>
</tr>
<tr>
<td>F statistics</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jarque Bera</td>
<td>1.07 (0.584)</td>
<td>0.019 (0.99)</td>
</tr>
</tbody>
</table>

Bracket values indicate probability values

The Lagrange Multiplier (LM) test tells whether there is a serial correlation among data or not. The value for F statistics is 0.939 and the Probability value is 0.4038 for equation 1, F statistics is
1.769 and the Probability value is 0.188 for equation 2. So, we do not reject the Ho hypothesis; by not rejecting the Null hypothesis it shows that there is no serial correlation. So, we do not reject Ho hypothesis. The Ramsey Reset test (Regression Equation Specification Error test) explains whether the equations have some specification errors or not. The value for F statistics is 0.2146 and its Probability value is 0.808 for equation 1 and F statistics is 0.6888 and its Probability value is 0.51 for equation 2. So, we do not reject Ho's hypothesis; the equations are free from Specification Errors. Jarque Bera test checks data normality distribution whether data is normally distributed or not. The F statistics value is 1.07 and the Probability value is 0.584 for equation 1 and F statistics is 0.019 and its Probability value is 0.99 for equation 2. It shows that data are normally distributed as stated in Figure 1.

<table>
<thead>
<tr>
<th>(Financial Institutions)</th>
<th>(Financial Markets)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean: 2.47e-16</td>
<td>Mean: 1.65e-15</td>
</tr>
<tr>
<td>Median: -0.260714</td>
<td>Median: 0.257253</td>
</tr>
<tr>
<td>Maximum: 3.386430</td>
<td>Maximum: 3.594250</td>
</tr>
<tr>
<td>Minimum: -2.548754</td>
<td>Minimum: -3.389419</td>
</tr>
<tr>
<td>Std. Dev.: 1.391999</td>
<td>Std. Dev.: 1.521184</td>
</tr>
<tr>
<td>Skewness: 0.381705</td>
<td>Skewness: -0.030651</td>
</tr>
<tr>
<td>Kurtosis: 2.608305</td>
<td>Kurtosis: 3.098824</td>
</tr>
<tr>
<td>Jarque-Bera: 1.073653</td>
<td>Jarque-Bera: 0.019723</td>
</tr>
<tr>
<td>Probability: 0.584601</td>
<td>Probability: 0.990187</td>
</tr>
</tbody>
</table>

**Figure: 1. Descriptive Statistics and Jarque Bera Test Results**

**Stability Test**
CUSUM and CUSUM Square check the stability of the parameters. It is perceived that parameters are stable when the blue line remains within the boundary of red lines and the blue line does not cross the red boundary lines. Figure 2 shows that the blue line is within the boundary of the red lines. So, the parameters for both equations are stable.
Ordinary Least Square (OLS)
The equations are estimated through Ordinary Least Square lags approaching. The variables stationary at level are run to their original state without lags whereas, variables stationary at first difference, by taking differentiation of those variables.

Table: 3. OLS approaching with Lags

<table>
<thead>
<tr>
<th>Variables</th>
<th>Financial Institutions</th>
<th>Financial Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>-2.45</td>
<td>6.154</td>
</tr>
<tr>
<td></td>
<td>(4.53)</td>
<td>(0.656)</td>
</tr>
<tr>
<td>MY</td>
<td>0.123**</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.056)</td>
<td></td>
</tr>
<tr>
<td>FDIY</td>
<td>-1.599*</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.567)</td>
<td></td>
</tr>
<tr>
<td>DWR</td>
<td>0.354***</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.184)</td>
<td></td>
</tr>
<tr>
<td>DBAY</td>
<td>-0.300**</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.125)</td>
<td></td>
</tr>
<tr>
<td>DPSCY</td>
<td>0.164</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.10)</td>
<td></td>
</tr>
<tr>
<td>DBDY</td>
<td>0.302***</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.1313)</td>
<td></td>
</tr>
<tr>
<td>DST</td>
<td></td>
<td>-0.0084**</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.003)</td>
</tr>
<tr>
<td>DCY</td>
<td></td>
<td>-0.137*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.033)</td>
</tr>
<tr>
<td>STY</td>
<td></td>
<td>0.007**</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.020)</td>
</tr>
<tr>
<td>F- statistic</td>
<td>4.721*</td>
<td>7.073*</td>
</tr>
<tr>
<td>R Square</td>
<td>0.502</td>
<td>0.406</td>
</tr>
<tr>
<td>Adjusted R Square</td>
<td>0.396</td>
<td>0.348</td>
</tr>
<tr>
<td>Durbin Watson</td>
<td>1.52</td>
<td>1.99</td>
</tr>
</tbody>
</table>

*** ** * shows level of significance at 10%, 5% and 1%
The bracket values are the Standard error

The M2 to GDP ratio has a positive impact on the economic growth of Pakistan and is statistically significant at 5%. If M2 to GDP increases by 1% then the economic growth of Pakistan increases by 12.3% on average, keeping the effects of other variables constant. FDI to
GDP ratio hurts the economic growth of Pakistan and is statistically significant at 1%. FDI to GDP increases by 1% then the economic growth of Pakistan decreases by 159.9% on average, keeping the effects of other variables constant. Worker’s remittance to GDP has a positive impact on the economic growth of Pakistan and is statistically significant at 10%. If Worker’s remittance increases by 1% then the economic growth of Pakistan increases by 35.4% on average, keeping the effects of other variables constant. The Bank’s asset-to-GDP ratio has a negative but significant impact on the economic growth of Pakistan. The Bank’s asset-to-GDP ratio increases by 1% then economic growth decreases by 30% on average, keeping the effects of other variables constant. Credit to the private sector to GDP has a positive impact on the economic growth of Pakistan and is statistically insignificant. The Bank’s deposit-to-GDP ratio has a positive and significant impact on the economic growth of Pakistan. The Bank’s deposit-to-GDP ratio increases by 1% then economic growth increases by 31% on average, keeping the effects of other variables constant. The stock turnover ratio is negative but statistically significant at 5%. The stock turnover ratio increases by 1% then economic growth decreases by 0.84% on average, keeping the effects of other variables constant. Market Capitalization to GDP ratio hurts the economic growth of Pakistan and is statistically significant at 1%. If Market Capitalization to GDP increases by 1% then the economic growth of Pakistan decreases by 13.7% on average, keeping the effects of other variables constant. The stock traded to GDP ratio has a positive impact on the economic growth of Pakistan and is statistically significant at 5%. If the Stock traded to GDP ratio increases by 1% then the economic growth of Pakistan increases by 0.7% on average, keeping the effects of other variables as constant.

F-test and R-Square
The F-test narrates the overall significance of the model. The f statistics value is 4.721, statistically significant at 1%. So, the overall model is significant jointly for eq 1. The F statistics value is 7.073 and statistically significant at 1%. So, the overall model is also significant jointly for eq 2. R-square tells about how much variation in dependent variables is due to independent variables. 52% variation in the Real GDP Growth Rate is explained due to explanatory variables. Adjusted R square tells the explanatory power of the number of predictors in the regression model. By adding new terms or variables, the value of the Adjusted R square decreases as compared to expected changes and vice versa. R square and adjusted R square reveal that the goodness of fit of the model is satisfactory for EQ1. For Q2, a 41% variation in the Real GDP Growth Rate is explained due to explanatory variables. Durbin Watson's statistic for EQ1 is 1.52 and 1.99 for EQ2. So, Durbin Watson's statistics for both equations lie between intervals of 1.5 to 2.5. It shows there is no autocorrelation.

Conclusion
Empirical analysis suggests that Pakistan lags behind other countries via financial institutions and market development. The purpose of this research is to check the impact of financial sector development including financial markets development and financial institutions development on sustainable economic growth of Pakistan. Conclusively, results show that financial institutions development particularly banks are playing a positive role in the real GDP growth rate of Pakistan. M2 to GDP ratio, Worker’s remittance to GDP, Credit to the private sector to GDP, Bank’s deposit to GDP ratio has a positive impact on the economic growth of Pakistan while FDI to GDP ratio, Bank’s asset to GDP ratio harms the economic growth of Pakistan and these results are supported by (King and Levine, 1993); (Levine 1996; Rioja and Velve, 2002), (Beckaert et al., 2005). Moreover, the financial market development is weak in Pakistan. The Stock turnover ratio indicates that the stock market of Pakistan is weak or inefficient and the Market Capitalization to GDP ratio has a negative relationship with the real GDP growth rate due to the worst Macroeconomic Indicators or a bearish market. Contrary, the stock traded to GDP ratio has a minor positive impact on the economic growth of Pakistan. According to Adnan (2009), the financial market development is playing a negative role in the real GDP growth rate in Pakistan.
due to weak, fragile, and inefficient market institutions.

**Policy Recommendation**

The efficiency of the financial institutions and markets should be ensured to maintain sustainable economic growth. The inefficiency of the stock exchange or financial markets ultimately leads to financial and economic instability. The key reason for the financial sector inefficiency is due to macroeconomic indicators, and political and government stability. Furthermore, the continuous domestic borrowing of the government causes a crowding-out effect and bars the financial sector from contributing to economic growth. Thus, the government restrains from borrowing domestically. The financial regulations and the environment need improvement to achieve the desired economic growth. Financial accessibility can be improved through financial inclusion of the lower segment of society and SMEs which are considered as unbanked people and unbanked firms. Financial openness is a key ingredient among financial development variables to enhance economic growth. Therefore, worker remittance and FDI are needed to improve further to contribute to economic growth more effectively.

**Reference**


