# The Impact of Economic Policy Uncertainty on Working Capital and Bank Stability: Evidence from Pakistan

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## ABSTRACT

The purpose of this research is to examine how uncertain economic policies (EPU) influence the funds available for a company's day-to-day operations (WC) and the stability of banks (BS). This research used a mix of static and dynamic analysis methods on data collected from 2010 to 2022. It was found that EPU negatively impacts the stability of banks, with this result being consistent across three different statistical tests at a 5% significance level. Additionally, the research shows that EPU positively affects how much working capital a bank has. These insights are important for those making economic policies, financial institutions, and companies in unpredictable economic situations.

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## 1.    Introduction

Bank stability is crucial for the economy, helping it grow, keeping public trust, and keeping the economy stable (Žuk-Butkuvienė, Vaitulevičienė, & Staroselskaja, 2014). Banks are important because they help move money between savers and borrowers, making sure funds are used effectively and helping economic activities to succeed. It is important to keep banks stable to avoid financial crises, safeguard people's deposits, and ensure the banking sector operates smoothly.

Bank stability includes financial health, the ability to handle sudden changes, good risk .situations like economic slumps, market disturbances, or big losses (Amidu & Wolfe, 2013).

Stable banks have enough capital, high-quality assets, manage risks well, and have strong liquidity. The stability of banks affects not just individual banks but also the entire financial system (Davies, Richardson, Katinaite, & Manning, 2010). Since banks are linked, the failure of one can impact others, causing wider financial problems. Therefore, regulators and policymakers keep a close watch on bank stability to protect the financial system's overall stability and integrity (Beck, De Jonghe, & Schepens, 2013).

The relationship between economic policy uncertainty (EPU) and bank stability is intricate and multi-layered. Economic policy uncertainty makes it difficult for banks to assess and manage risks properly. Banks depend on steady economic conditions to make wise lending choices, judge creditworthiness, and handle their loan portfolios (Hartzmark, 2016). Economic policy uncertainty (EPU) significantly affects the business climate for banks. Higher interest rates resulting from economic policy uncertainty (EPU) lead to increased borrowing costs and reduced growth in bank lending (Ashraf & Shen, 2019).

During times of high economic policy uncertainty (EPU), bad loans increase, reducing the value of bank assets. Households and businesses cut down on their investments in such periods, leading to a decreased demand for loans and a fall in interest rates. However, during high EPU periods, customers seek higher interest rates on their savings. This situation narrows the difference between the interest banks earn on loans and pay on deposits, impacting the bank's earnings (Hartzmark, 2016). Gradually decrease in profits thrust drive the banks financing in risky businesses which may destruct stability to sustain their normal profits levels (Baker, Bloom, & Davis, 2016). Also, economic policy uncertainty (EPU) enhance to advance market instabilities, as financial markets are precise approachable to policy deviations and news. Banks with substantial financing in insecure assets might see a depletion in their asset values, enervate their financial foundation and threatening their stability (Baker et al., 2016).

Working capital problems are also influenced by economic policy uncertainty (EPU). In financial institutions, working capital is the money compulsory for daily events, containing liquidity, cash flow, and short-term funding (Godswill, Ailemen, Osabohien, Chisom, & Pascal, 2018; Mandiefe, 2016). Banks require sufficient working capital to complete routine procedures, accomplish financial obligations as well as sustain a stable financial position. Conversely, economic policy uncertainty (EPU) may disturb the regular activities of bank's working capital, affecting potential issues and risks (Julio & Yook, 2012; Xu, Qian, & Li, 2013; Yunquan & Chunfang, 2013). Periods of high economic policy uncertainty (EPU) effect how decisions are made, effecting working capital management (Fang, Lu, Shieh, & Lee, 2021).

This research enhances to current study by directing on how economic policy uncertainty unswervingly effects the working capital in banks, an area not systematically inspected before. It simplifies how banks accomplish their working capital during uncertain periods, addressing this gap in previous research. Second, there is a lack of literature on the banking sector in association to economic policy uncertainty, and maximum of the researches generally attention on bank profitability and lending behavior (Ashraf & Shen, 2019; Bikker & Vervliet, 2018; Bilgin, Danisman, Demir, & Tarazi, 2021; Biswas & Zhai, 2021; Bordo, Duca, & Koch, 2016; Boungou & Mawusi, 2022; Gao, Ru, & Tang, 2021; Hu & Gong, 2019; Kim & Yasuda, 2021; Lee, Lee, Zeng, & Hsu, 2017; Nguyen, 2023; Shen, Hou, Peng, Xiong, & Zuo, 2021; Tran & Houston, 2021; Wang, Lee, & Chen, 2022). There is limited literature on the associaton among economic policy uncertainty and bank stability (Danisman & Tarazi, 2024; Shabir, Jiang, Bakhsh, & Zhao, 2021; Wu, Yao, Chen, & Jeon, 2020; Zhang & Wang, 2023). So, this study further enhances the literature in the area of economic policy uncertainty and its impact on the banking sector. Third, Pakistan's banking industry is less mature than its developed counterparts and tends to react differently to economic policy uncertainty. Previous research on how economic policy uncertainty (EPU) affects bank stability has mainly been conducted in developed countries. Therefore, it's very important and valuable to study the impact of EPU on bank stability in developing countries.

## 2.    Literature Review

Economic Policy Uncertainty (EPU) appertains to a situation in which the future direction of economic policy is uncertain and unpredictable and negatively impacts economic activities (Coronado, Martínez, & Venegas-Martínez, 2020). Abel (1983) describes economic policy uncertainty (EPU) as unforeseen variations affecting the economic environment and how these fluctuations in monetary, fiscal, and other government policies affect a firm's decisions. Uncertainty is a vital notion that dates back to Keynes (1937), which cannot be diversifiable. It may arise from various sources, which include policies of government, overall economic conditions, geographical events, and many other micro and macro factors that could affect the economy (Bernanke, 1983). Uncertainty about future policies also reduces consumer confidence, spending, and economic growth (Eberly, 1994). A significant level of economic policy uncertainty hurts several business operations that affect international trade and investment (Becker, Fetzer, & Novy, 2017).

Banks are a vital component of the economic system and are more delicate to macroeconomic policy variations. Bank stability means the bank's ability to sustain its performance over time, particularly during intensified economic policy uncertainty (EPU) (Shabir et al., 2021). Banks are more cautious about lending to individuals and businesses, especially during uncertain times. This uncertainty can decrease credit availability, harming economic growth and stability (Tran & Houston, 2021). Economic policy uncertainty (EPU) also impacts banks' investment decisions, as they may hesitate to invest in long-term projects or make significant acquisitions (Ashraf, 2021)

Banks reduce lending during higher economic policy uncertainty (Gong, Jiang, Li, & Wu, 2018). Firms and individuals delay investment and expenditure during uncertain times due to expensive loans (Hartzmark, 2016). On the other hand, higher deposit rates are demanded by depositors during uncertain times (Valencia, 2017). The combination of the down burden on borrowing rates and the upper burden on deposit rates narrow interest rate spreads, a crucial means of income for banks.

Danisman and Tarazi (2024) argued that increased political uncertainty is significantly related to decreased bank stability. This is not due to the situation of borrowers or customers but to changes in bank behavior. These adverse effects of economic policy uncertainty (EPU) on bank stability vary from bank to bank. Similarly, Wang et al. (2022) found a negative association among economic policy uncertainty (EPU) and Bank stability in China. Banks typically lessen their market risk during uncertainty, indirectly affecting bank stability. Nguyen (2023) examines the influence of economic policy uncertainty (EPU) on bank stability by taking data of 950 commercial banks in eight European nations. He finds that bank stability decreased between 2005 and 2020 because of economic policy uncertainty. He proposes tightening activity caps, capital requirements, governmental and private supervision, and other forms of regulation.

Nguyen (2023) argued that wholesale funding has an adverse influence on bank stability during uncertainty. The conditional influences of economic policy uncertainty (EPU) are minor in developed nations and for large, high-quality banks. Zhang and Wang (2023) pointed the effect of earning opacity on the affiliation among economic policy uncertainty (EPU) and bank stability. As per Outcome of research, economic policy uncertainty disturbs bank stability. Opacity leads as a connection among economic policy uncertainty and bank stability. Economic policy uncertainty inversely effects the stability of banks by enhancing them to fewer their market values and improve the purity of their earnings.

The effect of economic policy uncertainty on bank's working capital is also substantial. Working capital is dynamic for the financial handling of corporations, necessary for their operational efficiency and lasting feasibility (Wolmarans & Meintjes, 2015). Managing working

capital is necessary for businesses because it contains managing the corporation's short-term finances and debts to sustain activities smooth and financially stable (Kaczmarek, 2019).

Policy fluctuations can dispute businesses in planning and controlling their working capital properly because they might be uncertain about how policies will affect their events, sales, or cash flow (Baker et al., 2016; Bonaime, Gulen, & Ion, 2018; Handley & Limao, 2015; Nguyen & Phan, 2017). Having adequate working capital permits businesses to grasp unforeseen chances and weather economic slumps by providing a financial buffer (Weinraub & Visscher, 1998).

## 2.1. Theoretical framework

Theory, Liquidity Preference Theory, and Pecking Order Theory. This part describes each theory in detail and enhance their association to our conceptual framework.

### 2.1.1. Financial Fragility Theory

Financial fragility theory inspects how vulnerable financial systems and markets are to crises and distractions. It goals to recognize the factors and signs that impact the stability or weakness of financial systems and the effect of in stability on economic development and stability. An essential phase of financial fragility theory is the research of economic fragility. Economic fragility describe the intrinsic weaknesses or differences in an economy that arise its risk of financial instability. These weaknesses can be fiscal and monetary discrepancies, financial and environmental exposures, issues in current and capital accounts, and external effects.

Governments have been enforced to alteration of their fiscal, monetary, and other monitoring policies due to financial crises in the past few years (Cui, Wang, Liao, Fang, & Cheng, 2021; Gao et al., 2021; Shen et al., 2021). These structural adjustments and restructurings in economic and financial policies in the system of finance have formed uncertainties in the upcoming direction of government and captiously have impacted the economic and business-related (Al-Shboul, Maghyereh, Hassan, & Molyneux, 2020). These uncertainties have had far-reaching implications for financial markets, businesses, and the stability of banking institutions (Baum & Wan, 2010; Tang & Yan, 2010).

### 2.1.2. Liquidity Preference Theory

Keynes (1937) developed the Keynesian liquidity preference theory as a fundamental basis for working capital management. According to this theory, businesses hold higher cash levels for three motives: transaction, protective, and hypothetical. The transactional and protective purposes are more relevant to working capital. The transaction reasons relate to the firm's requirement for having cash on hand or money in order to meet ongoing commercial transactions.

Firms must keep cash on hand to pay for current expenses such as transportation, raw supplies, and wages, among other things. Firms save cash as a precautionary measure in case of unforeseen events. Any company will save money to deal with difficulties or profit from unexpected agreements. The Keynesian liquidity preference theory is related to this study. When applying the liquidity preference theory to working capital management, firms prefer to adopt conservative working capital management during uncertain times.

### 2.1.3. Pecking Order Theory

According to the Pecking Order Theory, companies prefer using internal sources of financing before seeking external financing (Feazell, Mayers, & Deschner, 1984). Internal financing primarily consists of retained earnings, which are the profits a company keeps after

paying dividends to shareholders. When a company uses retained earnings to finance its working capital needs, it reduces its reliance on external sources of financing like debt and equity.

By prioritizing internal financing, companies may have more flexibility in managing their working capital because they are not burdened with interest payments on debt or dilution from issuing additional equity. They can use retained earnings to fund short-term operational needs, including accounts receivable, inventory, and accounts payable. When applying the Pecking order theory to working capital management, firms prefer to adopt a conservative working capital policy during uncertain times.

## 3.    Empirical Methodology
## 3.1.   Data

The population of the study is all the scheduled commercial banks in Pakistan. In Pakistan, a total of 33 scheduled commercial banks are currently working. The list of the scheduled commercial banks is also present on the website of the State Bank of Pakistan. However, the sample compromise of 25 banks, eight banks were excluded from the sample due to the unavailability of data (four foreign and four specialized banks).

The time selected for the research is from 2010 to 2022. Data on net working capital and bank stability will be attained from the financial statements of the relevant banks. No bank data is available in Pakistan, so that data will be collected by hand. The financial statements are primarily available on the bank's website. Economic policy uncertainty (EPU) data will be attained from the state bank. The State Bank of Pakistan has developed the index for economic policy uncertainty (EPU) and computed it annually. State Bank Pakistan (SBP) developed the index into five steps.

First, monthly counts from articles attained containing terms relating to uncertainty (or uncertain, unpredictable, unclear, unstable), and economics (or economy) and one or many of the subsequent terms policy-related: monetary policy, fiscal policy, State Bank Pakistan (or SBP), FBR (or tax authorities), legislators, regulation, legislature, scarcity, government, reserves, taxes, tariffs, regulation. Second, once these raw counts are obtained, these have been ranked by the overall number of published articles in every newspaper monthly. Third, the standard deviation is measured for each scaled count for each newspaper from 2010 to 2020. Fourth, the scaled count of each newspaper is divided by standard deviation. Furthermore, finally, they figured out the simple average crosswise newspapers by month to aggregate the index. Data about control variables will also be attained from the financial statements of the respective banks.

## 3.2.   Empirical Methodology

To analyze the data, this study applies Pooled OLS, Random effect model, and Generalized Method of Moments Mode (GMM). The decision to employ the GMM model stems from its suitability for study objectives. GMM is well-suited when dealing with dynamic models, systems of equations, and situations where the data may not satisfy the classical assumptions of OLS (Ordinary et al.). GMM is particularly valuable in addressing misspecification, measurement errors, unobserved heterogeneity, and especially endogeneity.

### 3.2.1.Measure the Influence of Economic Policy Uncertainty (EPU) on the Working Capital of Banks

The econometric model helped to achieve the critical objectives of the study. To measure the implication of Economic policy uncertainty (EPU) on working capital, we use the methodology adopted by Manela and Moreira (2017). The equation is estimated as follows:

$$WC = \beta o + \beta_1\, EPU + \beta_{2-6}\, Control\ Variable + Ut_0$$

Where WC stands for working capital, EPU is economic policy uncertainty. Control variables are ROA, which represents the return on assets; CAD Capital Adequacy ratio; LEV, which represents the leverage; and IF, which represents the market inflation rate.

### 3.2.2. Measure the Impact of Economic Policy Uncertainty (EPU) on Bank Stability

The econometric model helped to achieve the critical objectives of the study. To measure the implication of Economic policy uncertainty (EPU) on net working capital, we use the methodology adopted by Danisman and Tarazi (2024). The equation is estimated as follows:

$$Z - Score\ = \beta o + \beta_1\, EPU + \beta_{2-6}\, Control\ Variable + Uto$$

Score represents Bank stability, EPU represents economic policy uncertainty, ROA represents the return on assets, CAD Capital Adequacy ratio, LEV represents the leverage, and IF represents inflation.

## 4. Result and Discussion

**Table 1**
*Descriptive Statistics*

| Variable | Obs | Mean | Std. Dev. | Min | Max |
|---|---|---|---|---|---|
| BS | 260 | 3.281 | 1.014 | 0 | 6.061 |
| WC | 260 | 7.111 | 1.502 | 0 | 8.361 |
| EPU | 260 | 1.961 | .148 | 1.735 | 2.317 |
| LEV | 260 | .917 | .039 | .739 | .984 |
| ROA | 260 | .009 | .008 | -.051 | .03 |
| CAR | 260 | .167 | .066 | .02 | .563 |
| CPI | 260 | 8.734 | 4.312 | 2.553 | 19.723 |

Table 1 presents the summary statistics of the key variables of the study. The table reports the number of observations, Mean, Standard deviation, Minimum, and Maximum. The term BS represents Bank Stability, WC represents Working capital, EPU stands for Economic policy uncertainty, LEV stands for Leverage, ROA stands for Return on Assets, CAR stands for Capital Adequacy ratio, and CPI represents consumer price index.

Table 2 represents the results of the economic policy uncertainty (EPU) and Bank stability. As expected, the economic policy uncertainty (EPU) has a negative and statistically significant impact on Bank stability (BS) in all three models. This indicates increased economic policy uncertainty (EPU) adversely affects the banks' stability. The results remain consistent across all three regressions, with the coefficients varying between -0.428 and -1.715. The results are significant at a 5 % probability level in regression models 1 and 2. In contrast, in regression model 3, the power of statistical significance increases to a 1 % probability level. The findings are in line with (Danisman & Tarazi, 2024; Nguyen, 2023; Phan, Iyke, Sharma, & Affandi, 2021; Shabir et al., 2021; Zhang & Wang, 2023). This implies that customers demand a higher rate of interest on their deposits during an era of high economic policy uncertainty (EPU). This reduces the interest rate spread and affects the bank's profitability (Hartzmark, 2016).

Banks are encouraged to capitalize on high-risk missions to maintain their formal profit level, which deteriorates bank stability (Becker et al., 2017). Similarly, when uncertainty is high, investors and lenders tend to become more cautious, reducing their willingness to fund banks. This can strain banks' liquidity positions, making them more vulnerable to funding shortages and

affecting their overall stability. The findings are in accordance with the financial fragility theory that economic uncertainty weakens or imbalances the financial system, which leads to financial instability. The Arellano-Bond and Sargen test statistics have shown that the GMM model has been correctly specified.

**Table 2**
***The impact of Economic Policy Uncertainty on Bank Stability***

| Dependent Variable | Bank Stability (BS) | | |
|---|---|---|---|
| **Independent Variable** | **Coefficients OLS (1)** | **Coefficients Random Effect (2)** | **Coefficients GMM (3)** |
| L | | | 0.271*** |
| | | | (0.087)(3.10) |
| EPU | -1.715** | -1.412** | -0.428*** |
| | (0.731)(-2.35) | (0.675)(-2.09) | (0.139)(-3.09) |
| Control | | | |
| Lev | 8.039*** | 5.382** | -0.973 |
| | (2.376)(3.38) | (2.694)(2.00) | (2.485)(0.39) |
| ROA | 6.748*** | 6.654*** | 6.741*** |
| | (1.421)(4.75) | (1.187)(5.61) | (1.737)(3.88) |
| CAR | 3.284** | 1.97 | -0.154 |
| | (1.349)(2.43) | (1.355)(1.45) | (1.581)(-0.10) |
| WC | 0.19 | 0.034 | 0.086*** |
| | (0.04)(0.48) | (0.041)(0.81) | (0.012)(7.02) |
| CPI | 0.41* | 0.034 | 0.011* |
| | (0.024)(1.70) | (0.022)(1.55) | (0.007)(1.66) |
| Constant | -2.312 | -0.3 | 2.935 |
| | (2.194)(-1.05) | (2.289)(-0.13) | (2.187)(1.34) |
| AR1 | | | 0.013 |
| AR2 | | | 0.841 |
| Sargen Test | | | 1.0000 |

Note: The dependent variable is Bank stability (BS). The Independent variable is Economic policy uncertainty (EPU). The control variables are Leverage (LEV), Return on Assets (ROA), Capital adequacy ratio (CAR), and consumer price index (CPI). Column 1 reports the results of pooled OLS. Column 2 reports the result of the random effect model, and column 3 reports the result of GMM. The first parentheses displays the standard error (SE), and the second parentheses displays the t-statistic (t-Stat). Whereas ***, ** and * represents 1%, 5% and 10 significant level.

Table 3 represents the results of the economic policy uncertainty (EPU) and Working capital. Economic policy uncertainty (EPU) has a positive and statistically significant impact on bank working capital (WC). This implies that the increase in economic policy uncertainty (EPU) forced banks to make investments in working capital. The results remains consistent across all three regression with the coefficients varying between +0.53 to +3.14. The results are significant at a 1 % probability level in all three regression models. The outcome don't contest Tandoh (2020) study, which specified an inversely associations among economic policy uncertainty (EPU) besides working capital. However, our outcome set with Keynes's liquidity preference theory.

As explained by Keynes (1937), high economic policy uncertainty (EPU) can enhance companies, comprising banks, to be more restrained and conventional in running their finances. This could result in banks arising their working capital as a security extent and sustaining a conservative working capital strategy in times of uncertainty. Banks may sustain more cash or assets that may rapidly be turned into cash throughout uncertain economic periods. The rise in interest rates during these periods may also fewer the claim for loans, lessening bank's net interest margins and profits. This decrease in profits may boost banks to enhance their working capital to mitigate against the drop in profits. The Arellano Bond and Sargen assessments ensure that the GMM model is properly specified.

**Table 3**
***The Impact of Economic Policy Uncertainty on Working Capital***

| Dependent Variable: Independent Variable | Working Capital | | |
|---|---|---|---|
| | Coefficients OLS (1) | Coefficients Random effect (2) | Coefficients GMM (3) |
| L | | | -0.491*** (0.02)(-24.16) |
| EPU | 3.147*** (1.155)(2.72) | 2.822*** (1.008)(2.80) | 0.535*** (0.127)(4.20) |
| Control | | | |
| Lev | -0.492 (3.853)(-0.13) | 0.401 (4.163)(0.10) | 2.349** (0.979)(2.40) |
| ROA | 3.695*** (1.716)(2.15) | 3.326** (1.24)(2.68) | -2.736 (2.259)(-1.21) |
| CAR | 2.583 (2.159)(1.20) | 3.953* (2.043)(1.94) | 6.006*** (0.602)(9.97) |
| BS | 0.048 (0.1)(0.48) | 0.081 (0.095)(0.85) | 0.055** (0.024)(2.28) |
| IFC | -0.092** (0.038)(-2.41) | -0.085*** (0.032)(-2.65) | -0.028*** (0.007)(-3.85) |
| Constant | 1.052 (3.488)(0.30) | 0.745 (3.488)(0.21) | 6.531*** (1.047)(6.24) |
| | | | |
| AR1 | | | 0.150 |
| AR2 | | | 0.130 |
| Sargen Test | | | 0.069 |

Note: Dependent variable is Working capital (WC). The Independent variable is Economic policy uncertainty (EPU). The control variables are Leverage (LEV), Return on Assets (ROA), Capital adequacy ratio (CAR), Bank stability (BS) and consumer price index (CPI). Column 1 report the results of pooled OLS. Column 2 reports the result of the random effect model, and column 3 reports the result of GMM. The first parentheses display the standard error (SE), and the second parentheses displays the t-statistic (t-Stat). Whereas ***, ** and * represents 1%, 5% and 10 significant level.

## 5. Conclusion

The conclusions express significant understanding of how economic policy uncertainty (EPU), financial stability, and working capital management are associated in a developing economy. Our outcomes indicate that economic policy uncertainty (EPU) expressively effects both working capital and bank stability. In particular, economic policy uncertainty (EPU) is positively connected with working capital in Pakistani banks. This proposes that businesses incline to be more careful with their cash management during uncertain economic periods, perhaps fevering risks related with economic instabilities.

Moreover, the study initiate that economic policy uncertainty (EPU) has an inverse effect on bank stability, expressing how uncertain economic situations can cause bank's financial health. This finding highlights the effects of unchanging and foreseeable economic policies on the stability of financial institutions. Governments should maintain policies that reinforce the flexibility of the financial segment, influencing banks to sustain adequate capital reserves and liquidity to manage with times of economic policy uncertainty (EPU). Future research should examine how economic policy uncertainty (EPU) influence other financial aspects of banks, like deposits, loans, and capital organization.

**Author's Contribution:**
Hafiza Maryam Maqsood: Drafting Introduction, Literature review and Study Methodology.
Saleh Nawaz Khan: Envisaged the idea, and supervised the whole research process, develop a study design.
Wajid Alim: Contribute to the study design.

Kashif Nawaz: Data collection, Referencing and Proofread

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