

Financial Liberalization, Trade Liberalization and Economic Growth Nexus in Pakistan

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Abstract

In recent times, many south countries are devising their economic policies by focusing on trade and financial liberalization because it is argued that both types of liberalization enhance the efficiency in the production process that leads to economic growth. To validate the finance-growth and trade-growth hypotheses in Pakistan, this study delves into the influence of financial and trade liberalization on the economic performance of Pakistan. The study has used annual time series data from 1974-2018. By applying the ARDL technique, the findings show a stable long-run association between financial and trade liberalization with economic performance in Pakistan.

Keywords: Financial Liberalization, Trade Liberalization Growth, Pakistan.

JEL Codes: F14, P33

1. Introduction

Financial and trade liberalization plays a central role to boost the economic performance. It is a reality that technology is a vital factor to achieve better economic performance for any nation, but technological absorption needs larger investment

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which is funded by financial institutions. More developed financial intermediaries and institutions provide an opportunity to the business firms for managing many funds more effectively which lead to economic performance. Similarly, trade liberalization leads to an increase in the welfare of the people by allocating the domestic resources efficiently and provide an opportunity for the country to take the benefits of comparative advantage. Trade liberalization also affects economic growth through indirect channels by influencing the major factors of economic growth like FDI, improvement in technology, human capital, and increasing the participation of the labor force (Anwar et al, 2011; Ellahi et al, 2011).

The financial and trade sectors have significance in the economic development of countries. The advancement of the financial sector determines how the scarce resources of the economy move from surplus units to deficit units efficiently. The financial sector helps in facilitating business transactions and promote economic growth. If the financial sector of a country is well developed, it will increase the volume of savings and investment. Likewise, more exchange of commodities across borders would augment economic growth.

Trade openness is an imperative element to determine the economic growth of a country. Primarily, it has been observed that most developing countries adopt restrictive policies about the trade sector. Though with the presence of globalization, all nations have realized the importance of trade openness and are liberalizing their economies. These trade liberalization policies have a great standing for the improvement of exports and the trade balance of the developing countries. Many underdeveloped countries of the world are still hesitant about the liberalization policies in their trade sector because it can adulterate their trade balance by increasing the volume of imports more than the exports after liberalization. Like many other developing countries, Pakistan has taken a lot of steps toward financial and trade sector liberalization to amplify economic performance (Sulaiman et al. 2012).

Many researchers have investigated empirically to find out financial and trade sector liberalization effectiveness for the economic performance of different countries. They have measured economic performance by taking GDP growth and show mixed results all over the world. This study is also investigating the nexus among financial liberalization, trade sector liberalization, and economic performance in Pakistan.

The rest of the paper is structured as: Section 2 explains the conceptual review of financial and trade liberalization. Section 3 gives a review of empirical studies. Section 4 presents the model, data, and methodology. Section 5 discusses results while section 6 is about conclusion and policies.

2. Financial and Trade Liberalization: Concept and Measurement

In this section, we present the concepts of financial and trade liberalization along with their measurement.

2.1 Financial Liberalization (FL)

Abiad et al. (2008) pointed out that there are eight vital factors through which financial liberalization occurred in any country in the world.

- Deregulation of credit controls
- Deregulation of interest rate
- Indirect monetary controls through reserve requirements
- Removing entry barriers of banks
- Privatization of banks
- Growth and development of the financial infrastructure
- Increase the supervision and regulations related to banks
- Foreign exchange market liberalization

2.1.1 Measurement of Financial Liberalization

There are different methods and techniques through which researchers have measured financial liberalization. To measure financial liberalization, many studies have used the proxies of M2, stock market capitalization, credit to the private sector. But some studies have constructed the financial liberalization index.

2.1.2 Money Supply (M2)

M2 as a percentage of GDP represents the financial depth of the economy and is used as a measure of financial liberalization.

2.1.3 Average Market Capitalization

Average market capitalization represents the state of the stock exchange market of the country. To measure the level of investment and financial policy behavior of the country, the total value of the stock market to GDP is used.

2.1.4 Credit to the private sector (percentage of GDP)

Credit to private sector represents the financial width of the financial sector in an economy.

2.1.5 Principal Component Analysis

PCA is used for constructing the financial liberalization index. We can use PCA to form the financial liberalization index by taking major variables of financial liberalization like broad money ratio (M2/Y), credit to the private sector (CPS), and average market capitalization (AMC). The financial liberalization index can be expressed as:

$$FL_t = a_1 (M2/Y) + a_2 (CPS) + a_3 (AMC)$$

2.2 Trade Liberalization (TL)

Liberalization of trade refers to lessening in obstacles related to the exchange of commodities abroad. It covers the policies related to the elimination of government restrictions, mobility of capital and labor force, and free transactions of goods and services across nations.

2.2.1 Measurement of Trade Liberalization

There are assorted indicators which are used to represent the trade liberalization in the literature. These variables are:

2.2.2 Export to GDP ratio

It represents the openness of the export sector and links export openness with economic growth based on the efficient allocation of resources in the economy. It means opening the export sector leads to the reallocation of resources among different countries according to comparative advantage theory. The efficient allocation of resources increases the level of exports on a large scale. The openness dimension related to the availability of inputs and scale economies is measured by taking the share of exports in total production.

2.2.3 Import to GDP ratio

The import share in the total production is utilized to indicate the openness dimension which relates to international competition. This ratio shows the significant effect of trade openness and the imports of those sectors which have comparative disadvantages. It will cause to promote trade liberalization.

2.2.4 Foreign Trade to GDP ratio

The total exports and imports share are utilized to measure openness in trade in total production. This ratio measures the technology spillover dimension of openness. Trade liberalization provides an opportunity for the countries in the world to get access to the technical information which leads to technological spillover through exports as well as imports.

2.2.5 Principal Component Analysis

PCA is used for constructing an index of trade liberalization. We can use PCA to make the index of trade liberalization by taking major components of trade liberalization like the ratio of export-GDP, ratio of import-GDP, and ratio of trade-GDP. The trade liberalization index can be expressed as:

$$TL_t = a_1(M2/Y) + a_2(X/Y) + a_3(X + M/Y)$$

3. Empirical Studies at a Glance

Now, we present the empirical work associated with financial and trade liberalization.

3.1 Financial Liberalization-Growth based Studies

The financial sector of a country performs a central position in the real sector growth of a nation. Several studies show a positive association of FL on economic growth in various countries.

Dritsakis and Adamopoulos (2004) investigated the causal relationship of financial development, openness, and economic growth in Greece utilizing data from the first quarter of 1960 to the fourth quarter of 2000. The multivariate autoregressive techniques were applied to time series data to find out the results. The Johansen cointegration technique concluded the positive link between economic growth and financial development in the long run. The findings of the Granger test evidenced bilateral causality between economic growth and financial development.

Rousseau and Vuthipadadorn (2005) explored the FD-economic performance link of 10 Asian countries by taking time series data over the past half-century. The authors had applied various time series techniques to explore the association of financial development indicators with real economic performance in the selected Asian countries. Credit allocated to the private sector, the difference between narrow money (M2-M1), and broad money were utilized to quantify financial development in the study. The economic performance of the ten Asian countries was measured by taking the gross domestic fixed investment and GDP. The findings of the study showed that FD is a key factor for gauging economic performance.

Chaudhry, Malik and Farook (2012) has examined the FL and macro-economic performance of Pakistan by taking time-series data from 1972 to 2006. The study inferred that the liberalization of the financial sector improves the economic performance in Pakistan.

Lal et al. (2009) probed the financial development-growth connection in Pakistan by utilizing the time-series data

set. The authors had divided financial development into two ratios: finance size and finance activity. Finance size measures the total size of banks and non-bank financial institutions while finance activity measures all the activities of these institutions. FS is used as a proxy of the financial structure showing that if it has a high value it represents the market-based system and the low value represents the bank-based system. The Johansen cointegration technique was applied to find out empirical results. The study suggested that FD is an imperious determinant for Pakistan's economic growth.

Perera et al. (2009) examined FD and economic growth nexus in addition to causality analysis by using data from 1955 to 2005 for the Sri Lankan economy. Several indicators were used to measure the FD. The conclusion is that financial development is unable to enhance the rate of growth in Sri Lanka.

Goaied and Sassi (2010) explored the influence of FD on the economic growth of sixteen nations of MENA by taking panel data set from 1962 to 2006. The authors had also probed the impact of Islamic FD on economic growth in the selected region. Islamic FD is measured by taking the amount of credit provided by Islamic banks to the private sector. The study had applied the GMM system on dynamic panel data to get results. The findings displayed that there was a negative bearing of conventional FD on growth while there was a positive but weak influence of Islamic FD on growth.

Anwar et al. (2011) examined the link of FD on economic growth along with the direction of causality between them. The time-series data were used for 1973-2007. Financial development is measured by taking the indicators one from banking and one from the stock exchange. ARDL approach to cointegration was applied to examine the association. The study pointed out that financial development had a positive and long-run relationship with the external debt-export ratio.

Sulaiman et al. (2012) investigated the association of FL and economic growth in developing countries especially of the Nigerian economy by utilizing time-series data from 1987 to 2007. The authors had measured the financial liberalization by M2/GDP, lending rate, inflation rate, exchange rate, and degree of openness. The authors had applied the OLS method in addition to Johansen's cointegration techniques. Results proved that financial liberalization stimulated economic growth in the Nigerian economy.

Rehman and Cheema (2013) examined the finance growth nexus for SAARC countries by taking data from 1975 to 2009. Financial development was measured by taking various factors from the banking sector. The panel data techniques were applied to explore the association between FD and growth in SAARC region countries. Findings concluded that FD was imperative for SAARC countries by concluding that the financial reforms that were started in SAARC countries were successful in achieving their goals.

Javed et al. (2014) emphasized the significance of financial sector development in the economic performance of Pakistan. The study had measured financial development through credit to private sector ratio, domestic credit to various sectors, and liquid liabilities. The findings revealed that FD had a positive effect on economic performance.

Keshavarzi and Akan (2014) investigated the financial development-growth link in Iran from 1980 to 2013. The indicator of M2/GDP was used to measure financial development and some other indicators are also used which affect economic growth like interest rate and domestic investment. ARDL technique was used. The findings proved that FD spurred economic growth in Iran.

Njikam (2017) pronounced that FL is not enhancing economic growth in forty-five African countries. The study confirmed no exact connection between FL and economic growth. Further, it showed that if some complementary

reforms were done then a positive link existed between FL and economic growth.

3.2 Trade Liberalization-Growth based Studies

There are many studies that are undertaken to explore the trade liberalization- growth link.

Siddique and Iqbal (2005) examined trade openness-growth association by taking the data set from 1972 to 2002 of Pakistan by measuring the trade openness by taking the total volume of trade. The study had applied the Johansen cointegration technique to find out the results. The empirical findings of the study indicated that trade-openness and GDP in Pakistan were negatively related to each other in the long-run.

Yasmin et al. (2006) examined the link between TL and economic development of Pakistan using data from 1960 to 2003. TL is gauged by the ratio of trade-GDP and import duties. The 2SLS regression technique was applied to avert simultaneity issues. The study proved that trade openness had not favorably affected economic development measures for Pakistan.

Chaudhry et al. (2010) explored causal association among TL, human capital, and growth in Pakistan. The study used the time series data from 1972 to 2007. The study had measured the trade liberalization by taking the ratio of trade-GDP. The study had used various econometric techniques. The findings exhibited that between TL and economic growth had a long-run relationship. The causality test proved that trade openness and human capital led to growth.

Oladipo (2011) explored the TL and economic growth relationship in Mexico by using data from 1980-1 to 2008-4. The Johansen cointegration technique was applied. The findings

proved that trade liberalization and capital investment led to growth in the Mexican economy.

Ellahi et al. (2011) investigated the trade openness-growth relationship in Pakistan by taking the period from 1980 to 2009. Ordinary Least Square method was applied to examine trade openness-growth link. The finding pointed out that trade openness was boosting growth in Pakistan and bi-directional causality between them.

Bourdon et al. (2011) showed a trade openness-growth link by considering some new dimensions to measure trade openness. The author suggested that the trade ratio did not represent the actual picture of the growth of any country unless we would consider the quality and variety of the exported products. The annual data of 158 countries were taken from 1980 to 2004 to estimate the hypothesis. The total export as a percentage of GDP, export quality, export variety, and investment were used as explanatory variables in this study. The GMM technique was applied to get results. The study concluded that the countries which were exporting higher quality and a wide variety of products grow more rapidly than the countries which were exporting lower quality and a limited variety of products.

Iftikhar (2012) probed the trade openness-growth nexus of Bangladesh from 1975 to 2010. The JJ-cointegration technique was employed to analyze the relationship between trade openness and growth. The results indicated that trade openness boosted economic growth in Bangladesh.

Asiedu (2013) explored the relationship of trade liberalization with real GDP in Ghana in 1986-2010. The author

had used ARDL & ECM techniques. The findings exhibited that trade liberalization promoted real GDP growth in Ghana.

Gnangnon (2018) investigated the link between multilateral TL and economic growth for 150 countries by using the data over 1995-2015. The findings confirmed positive causality between TL and growth.

In a nutshell, we can conclude from the above-mentioned empirical studies that there is a favorable bearing of financial and trade sector liberalization on economic performance.

4. Model, Data and Methodology

Now we explain models, sources of data, and methodology that we have used in the study.

4.1 Financial Liberalization and Economic Performance Model

$$GDPPC = f(LFPR, GFCF, SSE, CAP, DCFG, MVA) \quad (1)$$

We can present the econometric form of the equation (1) as:

$$GDPPC = \beta_0 + \beta_1 LFPR + \beta_2 GFCF + \beta_3 SSE + \beta_4 CAP + \beta_5 DCFG + \beta_6 MVA + \varepsilon \quad (2)$$

4.2 Trade Liberalization and Economic Performance Model

$$GDPPC = f(LFPR, GFCF, FTG, SSE, IMR, SVA, AVA) \quad (3)$$

We can show the equation (3) in econometric form as:

$$GDPPC = \beta_0 + \beta_1 LFPR + \beta_2 GFCF + \beta_3 FTG + \beta_4 SSE + \beta_5 IMR + \beta_6 SVA + \beta_7 AVA + \varepsilon \quad (4)$$

Where:

GDPPC	= Gross Domestic Product Per Capita
LFPR	= Labor Force Participation Rate
SSE	= Secondary School Enrollment Ratio
CAP	= Stock Market Capitalization (as % of GDP)
DCFG	= Domestic Credit Provided by Financial Sector (as % of GDP)
GFCF	= Gross Fixed Capital Formation (percentage of GDP)
MVA	= Manufacturing Value Added (percentage of GDP)
FTG	= Foreign Trade (as % of GDP)
IMR	= Infant Mortality Rate
SVA	= Services Value Added (percentage of GDP)
AVA	= Agriculture Value Added (percentage of GDP)

We have used annual time series data from 1974-2018 to carry out the empirical investigation by applying ARDL. The data source for this study is World Development Indicators.

5. Empirical Results and Discussions

Now, we explain empirical findings of financial and trade liberalization with the economic performance of Pakistan.

5.1 Bounds Test Results

The results of F-test are exhibited in Table 1

Table 1
Bounds Test Results

Models	F-statistics	@5%		@10%	
		I ₀	I ₁	I ₀	I ₁
1	5.23	3.41	4.69	3.13	4.37
2	6.70	2.86	4.57	2.57	4.23

The values of F-statistic are 5.23 and 6.70, which are greater than the upper bound critical values. So, these results point out that a long-run relationship exists in both models.

5.2 Long Run Results of Financial Liberalization with Economic Performance

The results of financial liberalization and economic performance are shown in Table 2

Table 2
Long Run Results

Variables	Coefficients	SE	t-Stat	Prob.
LFPR	1.0760	.2329	4.6199	.000
GFCF	0.4799	.1772	2.7080	.012
SSE	-0.4934	.1099	- 4.4888	.000
CAP	0.0895	.0293	3.0532	.005
DCFG	0.1133	.0459	2.5175	.019
MVA	0.2641	.2359	1.1240	.272

First, we elucidate the association of LFPR and economic performance. LFPR is a vital element for the better economic performance of a country. The share of the population which is willing to supply their labor into the market can have a greater bearing on the economic performance of a country. When labor force participation increases, it means more people are contributing to the production and the productivity of labor increases that promotes economic performance. The estimated parameter of LFPR is positive and significant. The results are consistent with our expectations.

The second explanatory variable is GFCF. It is also considered as an important factor for the economic performance of a country and its sign should be positive. The estimated parameter of GFCF in our model is positive and significant. Our results are matched with (Gibescu, 2010).

The next variable is secondary school enrollment. It is hypothesized that secondary school enrollment enhances human capital formation and economic performance. South countries like Pakistan are lacking to accumulate human capital. The

coefficient of secondary school enrollment is negative. It is a reality that this indicator is an important contributor to promote the economic performance of a country because it presents the improvement in human capital. But interestingly it shows a negative influence on economic performance in the case of Pakistan. The inverse relationship of the variable with economic performance is due to the reasons that secondary school enrollment is an input variable, not the output variable. Secondary school enrollment does not mean the enrolled students have completed their education because it may happen that they could not complete their education due to financial problems and a high dropout ratio. Therefore, they do not promote the economic performance of a country.

The coefficient of Stock Market Capitalization has appeared with a positive sign and it is also statistically significant. The sign of the variable is compatible with our expectations. The study by Chaudhry (2012) also found a positive bearing on the economic performance of Pakistan. Domestic credit also displays a positive effect on the economic performance of Pakistan. This variable enhances economic performance because when credit to the private sector increases, it will lead to an increase in real investment which stimulates economic performance. The studies by Vuthipadadorn et al. 2002; Padilla 2002, Chaudhry et al., 2007; Jalil and Ma, 2008) have also found a positive impact on economic performance. The coefficient of Manufacturing Value Added is positive and significant. So, our results are according to the expectations.

5.3 Error Correction Results

The error correction results are shown in Table 3. The coefficient of ECM is -1.2931 exhibiting that the high speed of adjustment.

Table 3
Error Correction Representation for the Selected ARDL Model

Variables	Coefficients	SE	t-Stat	Prob.
dLFPR	1.2564	.5548	2.2648	.032
dGFCF	0.6206	.2580	2.4051	.023
dSSE	-0.5043	.1775	-2.8405	.008
dCAP	0.1157	.0368	3.1415	.004
dDCFG	-0.0411	.0783	-.5244	.604
dMVA	0.3415	.3076	1.1103	.277
ecm (-1)	-1.2931	.1429	-9.0491	.000

5.4 Long Run Results of Trade liberalization with Economic Performance

We have displayed the long-run coefficients of the TL and economic performance model in Table 4.

The estimated parameters of LFPR and GFCF are again positive and significant statistically in this model. The foreign trade to GDP ratio represents the liberalization of the trade sector of a country. Trade liberalization allows the countries to enjoy the benefits of comparative advantage which improves economic performance by increasing economic growth. The widely accepted view among the economists is that the countries which have fewer restrictions on trade, grow faster than the countries that have restricted trade sector.

The coefficient of foreign trade to GDP is positive which is compatible with economic theory. The studies by Shaheen et al. 2013; Asiedu, 2013 have also found the positive impact of foreign trade on GDP ratio with economic performance.

The coefficient of secondary school enrollment is again negative. The coefficient of the Infant Mortality Rate is negative and statistically insignificant. The high ratio of infant mortality in any country has an inverse bearing on the economic performance of that country. The underdeveloped countries like

Pakistan are facing the problem of infant mortality. The coefficient of the infant mortality rate is negative and statistically insignificant in Pakistan.

Table 4
Long Run Results

Variables	Coefficients	SE	t-Stat	Prob.
LFPR	.5381	.1442	3.7310	.001
GFCF	.2533	.1317	1.9237	.065
FTG	.2006	.0639	3.1771	.004
SSE	-.2932	.0895	-3.2765	.003
IMR	-.0063	.0412	-.15063	.881
SVA	.2949	.1504	1.9617	.060
AVA	.0138	.1689	.0815	.936

SVA is positive and statistically significant. This variable expects that it promotes economic performance. So, our results are according to the expectations. Agriculture Value Added is also an important indicator for developing countries especially for Pakistan because Pakistan has been an agrarian country and 45% of the labor force is associated with this sector. This is the second-largest contributing sector after services to GDP. The coefficient of Agriculture Value Added is positive.

5.5 Error Correction Estimating Results

Table 5
Error Correction Results

Variables	Coefficients	SE	t-Stat	Prob.
dLFPR	.86936	.25254	3.4425	.002
dGFCF	.40936	.23542	1.7386	.093
dFTG	.32416	.10848	2.9881	.006
dSSE	-.10576	.17212	-.61444	.544
dIMR	-.010027	.066276	-.15129	.881
dSVA	.47656	.26887	1.7725	.087
dAVA	.022263	.27318	.081495	.936
ecm (-1)	-1.6151	.24541	-6.5840	.000

We show the error correction estimating results in Table 5. The coefficient of ECM term in this model is -1.6151 which indicates that the high speed of adjustment.

6. Conclusions and Policy Implications

This study examined the effect of financial and trade sector liberalization on the economic performance of Pakistan during 1974-2018. The results conclude that FL and TL have a positive and significant bearing on economic performance in the long-run.

It is important to mention some policies considering the facts.

- The study pointed out that domestic credit provided by the financial sector has a positive effect on the economic performance of Pakistan. Therefore, the financial sector must be given priority in making investment decisions for further improvement in the economic performance of a country.
- An effective and well-planned reduction in tariff barriers would increase the volume of trade. The study suggests that a well-developed and liberalized financial and trade sector is essential for further improvement in the economic performance of a country.

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