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The Missing Economic Magic: The Failure of Trade Liberalization and Exchange Rate Devaluation in Pakistan, 1980–2012

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Abstract

Pakistan and India were part of that wave of economic liberalization among developing countries from the late 1980s. This paper is about one aspect of that failure to 'produce the economic magic', in Pakistan. Pakistan substantially liberalized its international trade after the late 1980s, and contrary to some views managed its exchange rate in an exceptionally clear sighted and prudent manner. In response, Pakistan never experienced sustained and rapid export led-growth. In fact so disappointing was the performance of exports that Pakistan's degree of integration with the world economy was little higher in 2015 than it had been in 1990. This paper first examines the exciting promise followed by the lackluster performance of trade liberalization. It establishes evidence that the exchange rate was managed in a way that should have helped a more liberalized trading regime contribute to economic growth. The paper explores wider evidence linking trade liberalization to economic growth and argues that the positive relationship is at best only a contingent one. Those contingent factors that have failed to support the positive link between trade liberalization and economic growth in Pakistan are investment, tax revenue, and upgrading/learning.

Keywords: Trade liberalization, exchange rate, exports, Pakistan.

JEL classification: F19, O49.

1. Introduction

Pakistan and India were part of that wave of economic liberalization among developing countries from the late 1980s. What Bhagwati wrote about India could equally well have referred to Pakistan, if though Pakistan always had a little less state intervention and socialism than India. He wrote that the policy framework in India had stifled efficiency and growth, so while India, like Pakistan, had long maintained a reasonable rate of investment, the former suffered from an enduring problem of low productivity. This, Bhagwati blamed on the "extensive bureaucratic control

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over production, investment and trade," "inward-looking trade and foreign investment policies" and the "substantial public sector." Together, the "the deadly combination of industrial licensing and controls at home with import and exchange controls externally, effectively cut off the rigors of competition from all sources and made the creation of a rentier, as against an entrepreneurial, economy more likely" (Bhagwati, 1993, p. 60).

This was essentially an optimistic view. Bhagwati did not blame poor economic performance on any deep and durable determinant of economic growth, such as geography, institutions, colonial history, or culture, but instead on bad policy. And bad policy could be replaced by correct policy, so India (like Pakistan), in the late 1980s, needed "merely an appropriate policy framework to produce the economic magic that Jawaharlal Nehru wished for his compatriots" (Bhagwati, 1993, p. 98).

This paper is about one aspect of that failure to "produce the economic magic" in Pakistan. The country liberalized its international trade substantially after the late 1980s and, contrary to some views, managed its exchange rate in an exceptionally clear-sighted and prudent manner. In response, Pakistan never experienced sustained and rapid export led-growth. In fact, so disappointing was the performance of exports that Pakistan's degree of integration with the world economy was little higher in 2015 than it had been in 1990.

Section 2 first examines the exciting promise, and then the lackluster performance, of trade liberalization. Section 3 establishes evidence that the exchange rate was managed in a way that should have helped a more liberalized trading regime contribute to economic growth. In Section 4, the paper explores wider evidence linking trade liberalization to economic growth, and argues that the positive relation is, at best, only a contingent one. Those contingent factors that have failed to support the positive link between trade liberalization and economic growth in Pakistan are investment, tax revenue, and upgrading/learning. Section 5 concludes the study.

2. The Promise of Trade Liberalization and Outcome in Pakistan

This section first reviews the theory and evidence that import substitution was an unsuccessful economic strategy in the 1950s to 1980s across developing countries. This evidence provided much of the theoretical and empirical rationale for trade liberalization in Pakistan and India and in many other developing countries in the late 1980s and early 1990s. We then review the economic outcome in Pakistan, showing that, despite

undertaking extensive trade liberalization, the outcome was disappointing in terms of economic growth, export growth, and global integration.

2.1. The Promise

The basic trade model, structured around the impact of a tariff on a small developing country, forms the centerpiece of textbook treatments of international trade. The tariff will raise the price of imports and so, domestic consumer prices. Higher prices will encourage more domestic production (import substitution) and reduce domestic consumption. The tariff will raise revenue for the government. The first impact is redistribution from consumers (reduced consumer surplus) to producer profits and to government tax revenue. The second impact is a decline in efficiency as the lure of higher domestic prices/profits draws factors of production (land, labor, and capital) from other sectors to expand production in the now-protected sector.[1] The higher prices/profits received by producers cause them to increase production, using factors that were previously more efficiently employed in other sectors. This is the loss in production efficiency due to the tariff. The higher prices faced by consumers cause them to shift consumption to other goods and services that they preferred not to consume before the price rise. This is the consumption cost due to the tariff. These latter two effects represent pure efficiency losses to the economy as a result of the tariff. The benefit from trade liberalization (removing this tariff) would be a one-off reallocation of resources, removing this source of inefficiency.

Empirical evidence for the inefficiency impact of trade protection dates back to the 1970s and a number of OECD-sponsored studies of developing countries. Pakistan (Lewis, 1970) and India (Bhagwati & Srinivasan, 1975) were key case studies in this empirical effort. The results were drawn together in a summary volume by Little, Scitovsky, and Scott (1970). These studies found that the use of tariffs had, as intended, raised the relative price of industrial output and so motivated a shift of investment from agriculture to industry. These newly emerging industrial sectors were found to be very inefficient since tariffs had simultaneously removed pressures to compete against imports by improving quality or price competitiveness.

The use of overvalued exchange rates to reduce the cost of those imports of capital equipment and inputs necessary to promote industry was a common tool to promote import substitution. This tended to make exports less competitive and biased domestic production to the use of imported –

[1] The basic model assumes these factors of production were fully and efficiently employed before trade protection was imposed. The efficiency implications are less clear if trade protection causes formerly unemployed resources to be drawn into producing substitutes for imports.

and often capital-intensive – production methods. This latter feature led to slow employment growth as employers imported cheap machines to carry out tasks in factories and farms rather than employ people, which reduced the progress of poverty reduction and led to continued import dependence. The use of tariffs, quotas, and licenses to allocate resources replaced the market with a bureaucratic form of allocation and opened up opportunities for corruption in the political and administrative systems.

While the early development economists had focused on market failures as an argument against free trade, they had given no equivalent consideration to the possibility of government failure(s). They seem to have assumed that the state was some sort of selfless guardian that could costlessly intervene to promote import substitution in industry, ignoring the possibility that government failure could be worse than market failure. Decisions on economic policy are made by politicians who respond to political pressures. Using protection to create a new industrial sector automatically creates an interest group with a vested interest in retaining or increasing such assistance and which is unlikely to want any exposure to the perils of foreign competition (Krueger, 1990).

There is general agreement that the measureable benefits from reallocating resources as a consequence of trade liberalization are no more than 2–3 percent of GDP. To these direct costs of government controls or intervention, we then need to add all the resources expended in acquiring, protecting, and expanding the benefits from government intervention that protects against imports (rent seeking). Resources will also have been wasted by individuals who lobbied for, but failed to acquire, rents (Krueger, 1974).

These arguments were certainly influential. There was a general shift toward more open trade regimes the world over. In 1960, 22 percent of all countries (21 percent of the global population) had open trade policies, and by 2000 this had risen to 93 percent of all countries (and 46 percent of the world's population) (Wacziarg & Welch, 2008, p. 187).

2.2. *The Performance*

Beginning in the late 1980s, Pakistan substantially liberalized its economy. These changes sought to increase competitive pressures on incumbents by easing the entry of new producers and encouraging more imports into the country. It was anticipated that this would compel producers to upgrade and become more efficient and so enable them to expand and to export. To this end, trade liberalization, which began in 1987, continued deepening into the 1990s. The number of tariff slabs fell from 14 to 4, and the

maximum tariff fell from 225 percent in 1986/87 to 70 percent in 1994/95 and to 25 percent in 2001/02 (Hasan & Khan, 1994). Liberalization also encompassed the complementary areas of foreign investment (Kemal, 1999, p. 156) and finance (Husain, 2003; Khan, 1999; Zaidi, 2005).

The macroeconomic results were disappointing. GDP growth, which had averaged 6.0 percent between 1961/62 and 1991/92, fell to an average of 4.3 percent between 1992/93 and 2010/11, and this was around a declining trend (Kite & McCartney, in press). The growth of exports matched only this slowing economic growth so that the trade ratio (exports plus imports as a share of GDP) increased from 30.2 percent in 1990/91 to only 32.4 percent in 2008/09 (Pakistan, Ministry of Finance, 2010).

3. Exchange Rates: A Complementary Reform

As part of its efforts to promote domestic industry, for several decades after independence Pakistan maintained a fixed and overvalued exchange rate. The overvalued rate reduced the cost of those imported capital goods and raw materials needed to promote domestic industrialization. The trade balance was preserved by import controls to keep out equivalently cheap consumer goods and also various subsidies to push exports by offsetting the competitive costs of an overvalued exchange rate. Liberalization of those import controls in the late 1980s required an immediate complementary devaluation to prevent a sudden flood of imported consumer goods threatening the viability of domestic production and leading to an unsustainable balance-of-trade deficit. Over the longer term, devaluation was required to raise the competitiveness of exports and shift the economy toward greater export orientation.

Pakistan shifted to a managed float after 1982, which, in practice, meant the central bank intervening to smooth the rate at which the Pakistani rupee depreciated against the US dollar and other currencies; over the next two decades, the rupee depreciated from 10 to 60 to the dollar. There are two requirements for this ongoing depreciation to have had the intended positive impact on increasing (reducing) the competitiveness of exports (imports): (i) the Marshall–Lerner condition and (ii) the distinction between real and nominal devaluation. After discussing these two conditions, this section evaluates the management of the real exchange rate in Pakistan after 1990.

3.1. The Marshall–Lerner Condition

Devaluation will make exports more competitive by reducing their price in foreign markets, which should increase the demand for exports. The

devaluation will simultaneously make imports more expensive, so should reduce the demand for imports. For it to improve the balance of trade, the lower prices of exports must be offset by a higher export volume, and the higher prices of imports must be offset by a lower import volume. The Marshall–Lerner condition states that a devaluation will improve the balance of trade if the sum of foreign elasticity of demand for exports and the home country elasticity of demand for imports is greater than 1.

During the 1960s and 1970s, there was a widespread fear that this condition would not hold for developing countries. These "elasticity pessimists" argued that imports of capital goods, raw materials, petroleum, and food – being necessities for developing countries – would be insensitive to price (a low domestic price elasticity of demand). Moreover, exports of the raw materials typical of developing countries were often fixed in dollar terms in world markets and so, would be unaffected by devaluation (a low foreign price elasticity of demand). There was a shift in perception in the 1980s and the International Monetary Fund (IMF) and World Bank began to consistently demand devaluation as part of structural adjustment packages (Wood, 1991).[2] Some remain pessimists, arguing that the Marshall–Lerner condition does not hold in Pakistan (see Khan, 1994; Shah & Majeed, 2014), but the bulk of the evidence suggests otherwise – for Pakistan between 1972 and 1991 (Hasan & Khan, 1994), between 1980 and 2000 (Aftab & Aurangzeb, 2002), and between 1960 and 2003 (Afzal, 2004); for India (Joshi & Little, 1994); for seven Asian countries, including India and Pakistan (Hsing, 2010); and for both industrial and developing countries (Goldstein & Khan, 1985).

3.2. Real and Nominal Devaluations

Depreciation is most easily measured in nominal terms. We noted in the introduction to this section that the nominal rupee-dollar exchange rate depreciated from PRs 10 to PRs 60 per dollar over two decades. If prices in the domestic currency move to offset some of the change in the exchange rate, the real devaluation will be less than the nominal devaluation. For example, devaluation will raise the cost of imported capital goods and raw materials, and so raise the general costs of production in the domestic economy. Higher prices of imported consumer goods will raise the cost of living for workers and may stimulate demand for higher wages, again increasing costs of

[2] There is wide agreement that devaluation is likely to worsen the trade balance in the short run. Orders for imports and exports are often fixed in advance and it takes time to adjust domestic consumption patterns and production techniques to reduce the demand for imports and, likewise, time for domestic producers to expand production of exportables and substitutes for imports. This implies that price effects will lead to an immediate worsening of the balance of trade and only over time be offset by volume effects: more exports and declining imports. This is known as the J-curve effect.

production and prices in the domestic economy. The extent of this pass-through depends variously on the aggregate dependence of the economy on imports, the ability of workers and firms to defend wages and profit margins, respectively, and the ability of domestic firms to quickly substitute domestic production for more expensive foreign inputs at near-equivalent cost.

There is no evidence for Pakistan that domestic inflation has more than a limited impact in offsetting nominal devaluation. Choudhri and Khan (2002) find that, between 1982 and 1999, consumer prices in Pakistan were not responsive to the exchange rate, and the three occasions of sharp (more than 10 percent) devaluation between these dates had no obvious subsequent impact on inflation. In India, nominal devaluations likewise translate into real devaluations as inflation has little relation with exchange rates (Joshi & Little, 1994).

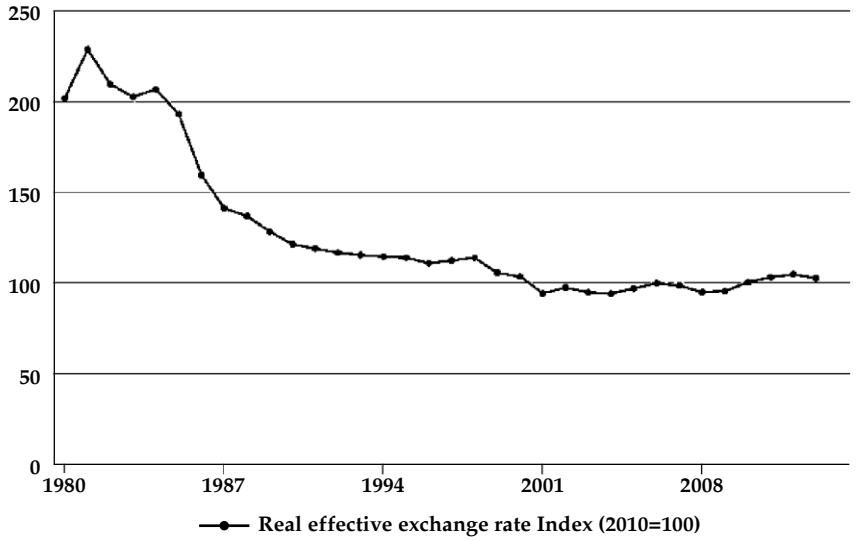
There is good reason to have expected these results. Between 1990 and 2008, imports accounted for only around 19–20 percent of GDP in Pakistan, indicating that devaluation would only have a minor impact on the overall price level (Pakistan, Ministry of Finance, 2010). There is also evidence that real wages have long been flexible in Pakistan, suggesting that depreciation is not generally resisted by higher wage claims (Amsden & van der Hoeven, 1996).

3.3. Evaluation of the Real Exchange Rate after 1990

In 1982, Pakistan switched from a fixed exchange rate to a managed float; this was temporarily suspended during the economic crisis linked to the sanctions imposed for nuclear tests in 1998 and the float was resumed in 2000. Figure 1 below shows the evolution of the real exchange rate in Pakistan over the last three decades or so.

The overvaluation of the very early 1980s was caused by the fixed rate with the dollar; the dollar underwent a massive appreciation on world currency markets after 1980 that pulled up the Pakistani rupee with it. The delinking with the dollar in 1982 saw a sharp depreciation of the Pakistani rupee and its gradual stabilization from the early 1990s to the present day. For the last 20 years, the Pakistani rupee has maintained a stable value by allowing the rate of nominal devaluation on world currency markets to offset the slightly higher domestic inflation in Pakistan that has been typical of its trading partners.

Figure 1: Real exchange rate in Pakistan, 1980–2012



Country: Pakistan
Created from: World Development Indicators
Created on: 03/15/2015

Source: World Bank (2015).

Capital inflows such as foreign direct investment (FDI), remittances, and foreign aid create a demand for the domestic currency, and so are typically found to be associated with a real appreciation of the domestic currency (Amuedo-Dorantes & Pozo, 2004; Janjua, 2007; Elbadawi, Kaltani, & Soto, 2012). Capital inflows into Mexico between 1988 and 1993, and again between 1996 and 2001, for example, caused a 30 percent real appreciation of the Mexican peso in both cases (Ibarra, 2011). After 9/11, Pakistan's decision to ally with the US brought immediate US influence to bear on reducing the former's international debt obligations. In 2001, Pakistan was granted debt relief on US$ 12.5 billion through lower interest rates and longer repayment periods, which saved US$ 1 billion annually in servicing costs. Foreign aid[3] increased from US$ 1 billion to 2 billion per annum in the 1990s to US$ 3 billion in both 2001 and 2002. The global boom of the early to mid-2000s led to even greater capital inflows into Pakistan.

World trade expanded by 0 percent in 2000 and by 10 percent in 2004; exports from Pakistan responded, expanding by 30 percent in 2003/04. Exports, which had been stagnant around US$ 9 billion–10 billion between 1996 and 2000, increased to US$ 15 billion in 2003 and US$ 19 billion in 2007. World FDI flows increased, and those going to Pakistan rose tenfold from

[3] Net official development assistance and official aid received in constant 2011 US$.

US$ 500 million in 2003 to US$ 5 billion in 2007. Migration from Pakistan took advantage of this rapid global growth, in particular professional migrants to the US and construction workers to the Gulf. As a consequence, remittance income to Pakistan increased from US$ 1 billion in 2001 to US$ 11 billion in 2011. This massive surge in various forms of capital inflows was completely offset by the monetary authorities and did not cause the Pakistani rupee to appreciate. The stability of the real exchange rate over 20 years is evidence of a very successful record of monetary management.

A more complex method of evaluating the success of exchange rate management can be achieved by comparing the actual real exchange rate with the underlying fundamental equilibrium exchange rate (FEER). This is defined as an

> … exchange rate that is expected to be indefinitely sustainable on the basis of existing policies. It should therefore be one that is expected to generate a current account surplus or deficit that matches the country's underlying capital flow over the cycle, assuming that the country is pursuing internal balance as well as it can and that it is not restricting trade for balance-of-payments reasons (Cline & Williamson, 2011, p. 2).

This comparison will allow us to observe whether the Pakistani rupee has been maintained at a level that is sustainable and consistent with long-term patterns of import and export growth, capital inflows, and economic growth. The statistical method is quite laborious and involves, first, measuring the real exchange rate[4] and, second, finding those factors with a statistically significant impact on the real exchange rate.

These factors typically include (in this case, measured in Pakistan relative to the rest of the world) technological progress, trade openness, government spending on nontraded and traded goods, external terms of trade, interest rates, and capital inflows such as foreign aid, FDI, and remittances. This is done for a large number of countries across a decent time period. Elbadawi, Kaltani, and Soto (2012) use 82 countries between the years 1980 and 2004. For those variables found to have a statistically significant impact on measures of the real exchange rate, we then need to plug in their estimated sustainable values into the regression equation to

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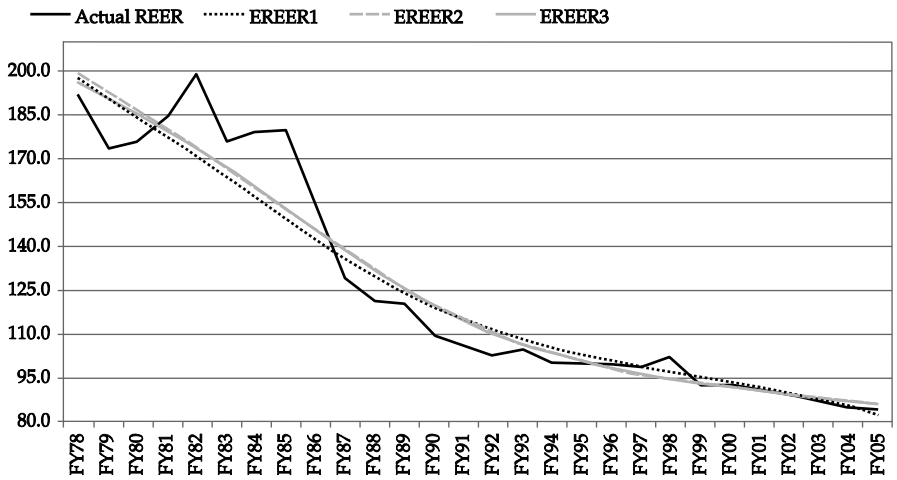
[4] See Wood (1991); White and Wignaraja (1992); Masters and Ianchovichina (1998); Krueger and Chinoy (2004); Qayyum, Khan, and Zaman (2004); Kemal and Qadir (2005); and Carrera and Vergara (2012).

produce an estimate of the FEER at a particular moment in time, and repeat this process over time to produce a time-series estimate of the FEER (Amuedo-Dorantes & Pozo, 2004; Hyder & Mahboob, 2005).[5]

Figure 2 shows a measure of the real exchange rate in Pakistan (the black line) and three estimates of the FEER (the red, green, and blue lines). There was a period of overvaluation in the early 1980s and undervaluation of the Pakistani rupee in the early 1990s. Since about 1990, there have been 15 years of remarkably successful monetary management in which the value of the Pakistani rupee has been held very close to its underlying equilibrium value. There was a small blip in 1998, connected with the nuclear testing sanctions, and no indication of any misalignment despite the massive surge in capital inflows after 2001. Figure 1 above shows some relatively small appreciation of the Pakistani rupee after 2008, which may indicate a degree of overvaluation; this could be verified by extending these FEER calculations.

Figure 2: Misalignment of the real exchange rate



Source: Hyder and Mahboob (2005, p. 17).

4. "I Am Puzzled: Where Has All the Growth Gone?"

Pakistan liberalized its trade regime substantially and managed its exchange rates in the years after 1990 in a way that gave exporters a stable incentive to export. Section 2.2 showed that the growth of the economy and of exports remained disappointing after 1990. So what happened to export growth? Studies of trade liberalization show that it has a more nuanced link

[5] Quite what is a sustainable level of foreign aid, remittances, government spending, and so on, is a subjective estimate dependent on the researcher's model of the world and of Pakistan's economy.

with economic growth than was anticipated in the criticisms of import substitution discussed in Section 2.1.

4.1. Studies of Trade Liberalization

Three-plus decades of global trade liberalization have generated ample data with which to study the impact of trade liberalization on economic and export growth.[6] Dollar (1992) has constructed an index that measures the extent to which the real exchange rate is distorted away from its free-trade level by the trade regime through, for example, import tariffs or export subsidies. He finds that this index has a significant and negative relation with investment and growth, and concludes that, "outward-oriented countries grow more rapidly." However, changes in the real exchange rate due to concerns about a country's debt solvency, for example, would be likely to produce large changes in the index for reasons unrelated to trade policy.

Sachs and Warner's influential index (1995) uses a binary measure that classifies countries as either "open" or "closed." Their index labels countries as "open" if they fulfill five criteria: (i) average tariffs are less than 40 percent; (ii) nontariff barriers cover less than 40 percent of imports; (iii) the country does not have a socialist economic regime; (iv) there is no state monopoly of major exports; and (v) the black market premium on the exchange rate exceeded 20 percent in either the 1970s or 1980s. The index accounts for the difficulty otherwise faced in statistical work that there are different ways to close the economy. The authors show that, between 1970 and 1989, countries passing all five tests had GDP growth 2.5 percent higher than those not passing all five.

This index has been criticized as only two of these variables ("state export monopoly" and "black market premium") explain most of the growth impact of the index, and these variables are, in turn, correlated with other determinants of growth. State export monopolies are closely related to being a country in sub-Saharan Africa, and the black market premium to being a country in Latin America. Therefore, the statistical tests of the index actually conclude that sub-Saharan Africa and Latin America were slow-growing in the 1970s and 1980s and so the index was really a proxy for variables uncorrelated to trade policy (Rodriguez & Rodrik, 1999).

Three studies address these specific empirical problems. The first notes that, despite the problems with methodology, the results of test after test point relentlessly to trade liberalization having a positive effect on

[6] See McCartney (2015, chap. 10) for a more detailed discussion of this debate.

growth (Edwards, 1998). The second improves measures of trade policy (Dollar & Kraay, 2004), and the third corrects many of the problems in the 1995 Sachs and Warner paper (Wacziarg & Welch, 2008).

Edwards (1998) uses nine different indices of trade policy for 93 countries and finds a generally positive link between openness and productivity growth. Dollar and Kraay (2004) make a statistical effort that addresses some of the concerns raised by the critics. A key problem in many studies is that there is no generally accepted measure of trade policy or trade liberalization. Dollar and Kraay use decade-by-decade changes in trade volumes as a proxy for changes in trade policy. Focusing on changes in trade volume means the results are less likely to be driven by fixed geographical factors, such as whether a country is landlocked. They define those countries that cut import tariffs significantly (by 22 percentage points on average) as "globalizers" and the rest (by 11 percentage points on average) as "nonglobalizers." Among the globalizers, GDP growth was 1.7 percent per annum in the 1970s, 2.6 percent in the 1980s, and 5.3 percent in the 1990s. Nonglobalizers experienced –2.8 percent (negative) growth in the 1970s, 0.2 percent in the 1980s, and –0.8 percent (negative again) in the 1990s. This measure is better and the results more convincing, but it is still not ideal. Changes in trade volume can happen for reasons unrelated to policy, such as bad weather reducing output and so, exports of agricultural goods.

Wacziarg and Welch (2008) update the data, method, and results from Sachs and Warner (1995) to present a comprehensive cross-country database of trade indicators (tariffs, nontariff barriers, and other measures of trade restrictions). This new dataset includes more data on nontariff barriers and 30 new countries. The Export Marketing Board variable from Sachs and Warner that was criticized as applying only to African countries is expanded in the new dataset to encompass any form of state monopoly over exporters and so, no longer applies to just African countries. They also extend the Sachs and Warner results on outward orientation and growth into the 1990s. Finally, they identify the changes in growth, investment rates, and openness associated with a significant change in trade policy. They define a date of openness as being that moment after which all the Sachs–Warner openness criteria are continuously fulfilled. Over the entire sample period (1950–1998), Wacziarg and Welch find that the growth of per capita GDP was 2.71 percent in a country with an open trade regime and 1.18 percent in a country without an open trade regime.

The results vary over time. Trade openness in the 1970s has a weaker impact than in the 1980s, and the impact of trade openness is positive, but

only very weakly so, during the 1990s. They also examine how GDP growth and investment rates evolved for 20 years before and after liberalization in a sample of 81 countries that achieved permanent openness. The results show that economic growth increased from 1.5 to 3.0 percent after reforms, and the impact was immediate and persistent. The investment rate took off during the 10 years after openness and remained high thereafter. After separating out other reforms (such as domestic deregulation and privatization), they find that it was trade openness that explained the bulk of the positive impact on growth and investment.

The empirical and case study results generally indicate a positive, if small, but nonrobust and variable link from trade liberalization to economic growth. For Pakistan, studies generally find a positive link between trade liberalization and economic growth (see Iqbal & Zahid, 1998; Ahmad, Alam, & Butt, 2003; Din, Ghani, & Siddique, 2003; Khan & Qayyum, 2007), although some studies find no link (Ahmed, Butt, & Alam, 2000; Akbar & Naqvi 2000). There have been brief interludes when macroeconomic reform has clearly led to rapid export growth, such as after the 1972 devaluation (Kemal & Alvie, 1975) and with stabilization in the early 2000s (Lorie & Iqbal, 2005).

A good reason for this uncertainty is that we are asking the wrong question. Rather than asking if trade liberalization is good for growth, we would be better to ask: under what circumstances is trade liberalization good for growth in Pakistan? There is very good reason to believe that the relationship is a heavily contingent one. Trade liberalization is only likely to be good for growth if there is complementary strategy to promote private investment, if government revenue from trade taxes is adequately replaced from other sources to fund public investment, and if trade liberalization leads to industrial/technological upgrading.

4.2. Trade Liberalization and Investment

Trade policy reform only works to the extent that it motivates entrepreneurs and workers to shift factors of production (land, capital, and labor) away from sectors where they are less productive (import-substitution or nontraded sectors) to more productive (export-oriented or traded) sectors. In the process, there are various adjustment costs such as those of retraining workers or the physical loss of machinery that cannot be converted for production in new sectors. This shift will inevitably require increased investment.

The availability of resources for investment was not a constraint in Pakistan during the 2000s. If savings were scarce and were constraining

investment, we would expect to see high foreign debt or a high current account deficit as signals that the country was drawing resources from elsewhere to compensate for low domestic savings. Or, we would expect to see competition to attract the existing limited pool of savings, leading to high interest rates for depositors or government bondholders. None of these phenomena were evident in Pakistan in the mid-2000s. At around 24 percent of GDP, savings in Pakistan were similar to the rates prevailing in other developing countries. Foreign debt was declining, the current account was showing sharp improvement, and the real interest rate was low or even negative: borrowers were not chasing scarce savers. Investment remained below savings, indicating that banks had a surplus of funds they could have lent for productive use. Investment rates above 30 percent of GDP are typically associated with rapid growth elsewhere in Asia, while investment below 20 percent of GDP characterized Pakistan through much of the 1990s and 2000s.

Section 4.3 shows that reduced and less productive public investment in Pakistan from the early 1990s was in part responsible for stagnating private investment. This section argues that high potential returns to private investment in Pakistan were lost due to a problem of appropriability. After a decade of tax cuts on corporations, high taxation was not appropriating these returns by the mid-2000s. The problem was rather caused by poor property rights and weak contract enforcement. Throughout the 1990s and 2000s, Pakistan had most of the symptoms of low appropriability of returns, which can be easily observed from looking at the various Global Competitiveness Reports produced by the World Economic Forum. Launching a small business was a long, expensive, and cumbersome procedure. A poorly functioning legal system made banks reluctant to lend as they faced a significant default risk from borrowers. Those borrowers could then continue for years until being declared bankrupt by a corrupt and inefficient court system, and be mandated to repay the debt; even then, once assets were scheduled for auction to repay debtors, they would typically disappear. Lending for property in Pakistan was hindered by inefficient, unclear, and frequently disputed rights to land and land titling. The proximate constraint to growth was low investment and its deeper causes lay in the lack of protection afforded to potential investors (McCartney, 2015).

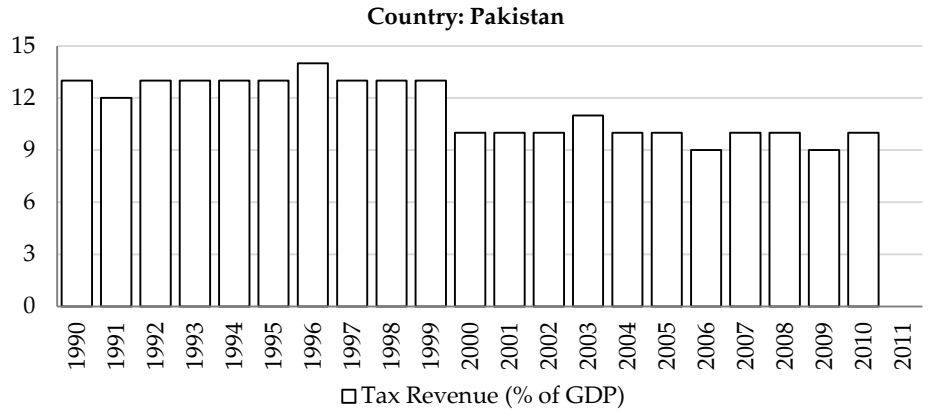
4.3. Trade Liberalization and Government Revenue

This section shows that trade liberalization in Pakistan directly reduced government tax revenue, leading to lower public investment, which, in turn, undermined private investment. This was not surprising:

trade liberalization in a developing country will near inevitably lead to a loss of government revenue and so, force fiscal adjustment elsewhere. The structural features typical of a developing country such as Pakistan include (i) the large, dispersed, low-income subsistence sector in agriculture and small-scale informal sector in urban areas, (ii) the weakness of the tax administration, and (iii) the lack of good accounting systems. Together, these make raising tax revenue from income and consumption taxes very difficult. Imports tend to enter Pakistan through a few ports and airports, and so are easier to collect taxes on than on the millions of income earners or consumers or thousands of (small) businesses (McCartney, 2012).

In the 1990s, trade taxes (predictably) contributed almost 35 percent of tax revenue in low-income countries and less than 1 percent in high-income countries. Between 1970 and the late 1980s shows that developing countries, especially the lowest-income countries, suffered declining tax revenues as a result of trade liberalization, which forced reductions in infrastructure and education spending (Khattry & Rao, 2002; Khattry, 2003). Figure 3 shows that tax revenue has remained low in Pakistan as the government failed to raise revenue elsewhere to compensate for revenue lost from reduced tariffs.

Figure 3: Tax revenues in Pakistan, 1990–2010

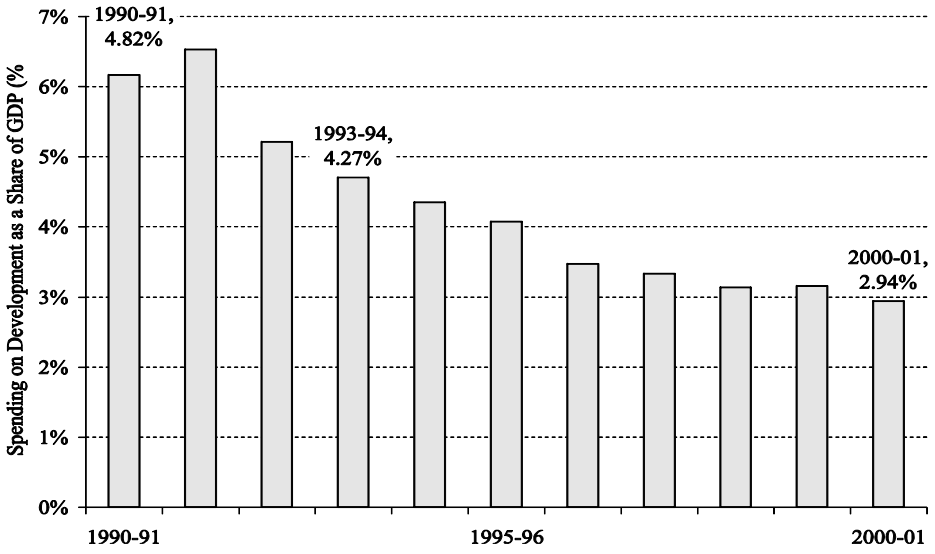


Source: World Bank (2014).

Public investment in complementary sectors such as transport, power, and ports, has been found to have a clear positive impact on crowding in private investment in Pakistan (Ahmed & Qayyum, 2007; Hyder, 2001; Naqvi, 2002). Revenue constraints and simultaneous pressure from the IMF for Pakistan to reduce its budget deficit led directly to the

reduced public investment from the early 1990s shown in Figure 4. This contributed to the stagnation of private investment discussed in Section 4.2.[7]

Figure 4: Spending on development as a percentage of GDP



Source: Fatima and Ahmed (2001, p. 513).

4.4. Trade Liberalization and Technological Upgrading

World trade in textiles and clothing boomed in the 2000s, increasing from US$ 157 billion in 2000 to US$ 250.7 billion in 2010. Textiles remains Pakistan's leading export sector, but performed poorly against this favorable backdrop. Exports from Pakistan of all textiles increased from US$ 11 billion in 2006/07 to only US$ 12.5 billion in 2011/12, and this around a fluctuating rather than rising trend. Domestically, the textiles sector experienced growth of less than 1 percent per annum in 2010/11, 2011/12, and 2012/13.

The technological complexity of Pakistani exports is important as different technology structures have different implications for growth. Demand for high-technology products tends to rise rapidly in world markets (termed a more income-elastic demand), which offers more potential for rapid export growth. High-technology products also offer

[7] There is also evidence that, during the 1990s, both political pressures and cost cutting weakened the institutional capacity for public investment. As a result, the remaining smaller amount of spending on development projects proved considerably less productive. For example, formal approval procedures were often bypassed for work, roads, and energy expenditures. By the end of 1996, this had led to PRs 700 billion worth of questionable projects being started, when only PRs 85 billion–90 billion per year was available to complete them (McCartney, 2011, p. 183).

greater potential for spillover effects in terms of creating new skills and learning. Simple technologies are more vulnerable to being replaced by new technologies and by waves of new lower-wage competitors to the market.

There is strong empirical evidence in support of these arguments. Between 1985 and 1998, world exports of primary products grew by 3.4 percent per annum, low-technology manufactured exports by 9.7 percent, and high-technology manufactures by 13.1 percent (Lall, 2000, p. 344). These differential growth rates resulted in significant changes in the structure of world trade. The share of resource-based exports fell from 23.7 percent of world exports in 1985 to 17.3 percent in 1998; low-technology and medium-technology exports remained stable (18.6 and 18.8 percent, and 40.9 and 38.9 percent, respectively); and high-technology exports increased (from 16.8 to 25.1 percent) (Lall, 2000, p. 351). In Pakistan, the share of (simple) cotton manufactures, leather goods, and rice accounted for two thirds of all exports throughout the 2000s (Pakistan, Ministry of Finance, 2014) and represented a structural impediment to faster export and economic growth.

Textile machinery is easily available in international markets at competitive global prices. Productivity on even standardized machinery varies dramatically: it was four times greater in Mauritius than Ghana in the 1990s, using similar production technology in manufacturing, and for large firms wages were only three times as high. This combination gave Mauritius a significant competitive advantage (Teal, 1999). Thai firms in the 1990s produced three times as much value added from given capital and labor in textiles and food processing than Kenyan firms in the same industries (Zeufack, 2001).

Upgrading requires not just buying, but also, more importantly, learning to use new technologies; this process is often slow, risky, and costly. Learning by doing may imply a lengthy and unpredictable period of losses as firms learn and adapt technology to make it more appropriate to developing-country conditions. Low productivity can also be explained by the lack of knowledge about activities such as managing modern factory layouts, inventory management, sales, and servicing (Khan, 2008).

In theory, private capital markets could spot this potential profit and so, fund firms through the initial period of learning. In practice, uncertainty, risk, and illiquidity mean that private capital is often reluctant. Firms in developing countries may then simply compete on the basis of sweated, unskilled labor and producing simple products more cheaply. This broadly characterizes Pakistan over the last 20 years where low-wage and low-skilled labor produces the two thirds of exports characterized as simple

textiles (and rice) and competes on the basis of low prices. Such a low road of development may be an ideal path for a single firm, but there are likely collective and dynamic benefits from following a high road of competition based on learning, productivity, skills, and upgrading (McCartney, 2011).

Given these market failures, there may be a valid case for government intervention to promote "infant industries." Industries or firms that have the potential to be competitive (the infant can grow up) need nurturing through the process of learning. This nurturing is known as "industrial policy." Protection against imports or the provision of subsidies may give space for firms to learn without facing the potentially destructive consequences of competition from established global producers. Such help may also, perversely, reduce the incentive to learn by removing the pressure of competition. Any such industrial policy must provide offsetting incentives in the form of performance requirements that are carefully monitored and enforced, such as an obligation to meet export targets (Lall, 1992).

A firm could contract with a bank to supply this effort in return for a loan and promise to repay that loan from future profits. In Pakistan, though, there is no credible means to ensure the accurate disclosure of profits or to enforce the rights of banks and shareholders. Calls to better enforce the rule of law, reduce corruption, and increase transparency are at best very long-term solutions and won't help revive economic growth or upgrade the structure of exports in the next few years.

Another solution would be to provide a direct subsidy on the cost of acquiring technologies. The 2005/06 budget in India established a Technology Upgradation Fund to invest US$ 700 million in the textiles sector. This fund aimed to encourage the private sector to set up world-class integrated textile complexes by helping finance investment in 50,000 shuttleless looms and modernizing 250,000 power looms. Under the fund, manufacturing firms became eligible for long- and medium-term loans from state banks at an interest rate 5 percent lower than the normal bank lending rates. Imports of textile machinery items and raw materials, and of parts for manufacture of such machinery were permitted at concessional customs duty.

The Textiles Policy 2009–14 produced by the Ministry of Textiles in Pakistan was a similar effort, though much broader in its ambition. The policy recognized many of the constraints faced by the textiles industry, such as the lack of adequate infrastructure facilities, availability of land and skilled labor, and the regulatory framework that imposed excessive burdens on business. However, the plan lacked any kind of clear focus. In fact, it was less a plan than a long list of aspirations: to develop state-of-the-art

infrastructure; to increase the supply of skilled labor; to legislate for higher standards of production at each stage of processing; to promote research and development to achieve product diversification; to increase productivity throughout the value chain (especially the quality and diversity of fibers); to support the development of allied industry such as machinery manufacturing, dyes, and chemical industry and accessories; and to encourage exports. This effort was costed at US$ 8 billion, but the policy subsequently fizzled out in consequence of its unclear objectives and in response to IMF pressures to reduce public spending.

5. Conclusion

This paper started optimistically enough and faded away. It began by looking at the promise of trade liberalization – the idea that policy liberalization could energize economic and export growth. It was an optimistic idea compared to, say, Diamond (1998), who argues that contemporary income differentials in the global economy were largely determined by environmental and geographical factors in 11000 BCE. But the promised economic magic never happened in Pakistan: with extensive trade and domestic liberalization went slower economic growth. This is surprising. The often-blamed culprit of poorly managed or overvalued exchange rates undermining the benefits of trade liberalization was innocent in this case.

In fact, Pakistan managed its exchange rate in an exceptionally clear-sighted and prudent manner.[8] A close examination of some of the seminal works exploring the link between trade liberalization and growth shows them to all have methodological problems: in particular, how does one measure "trade liberalization" for the purposes of statistical testing? But their results tend to be far less robust, more varied, and less predictable than strong advocates of free trade allow for. The relation is, at best, only a contingent one. This paper has argued that trade liberalization only works when (i) it is supported by a strategy to promote private investment, (ii) government finances are protected from revenue loss due to trade liberalization in order to finance the necessary public investment, and (iii) firms overcome learning failures in the use of new technology to upgrade and experience export-led economic growth.

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[8] The data discussed in this paper extends up to 2012; over the last couple of years, IMF staff have "stressed that the recent appreciation of the dollar against other currencies, the lack of downward exchange rate flexibility, and a high inflation differential relative to trading partners has caused a further loss of Pakistan's export competitiveness in world markets" (IMF, 2015, p. 12). Such a localized appreciation can be easily missed when graphing time-series evidence over several decades. This recent concern needs a much more focused analysis than the broader scope of this paper has allowed – thanks to Alan Whitworth of DFID Pakistan for drawing my attention to this recent evidence.

Understanding why trade liberalization failed to generate export growth is not the end of the analysis. Identifying a problem is not the same as identifying a policy reform or solution. The deep factors explaining why investors cannot appropriate returns are not amenable to quick solutions. Poorly protected property rights can confer enormous benefits on the powerful or politically well connected who can derive incomes through predation, bribery, or confiscation. The big lesson from Acemoglu and Robinson's (2012) book, *Why Nations Fail*, is that "bad" (or what they term "extractive") institutions are likely to persist if they can be used by elites to extract resources for their own benefit. Those resources will in turn provide the incentives and material capacity to organize, mobilize, and control political power to sustain the bad institutions and so, ensure that their elite status is perpetuated. Bad institutions create extractive elites who, in turn, support bad institutions in the form of a vicious circle.

Prosperity, argue Acemoglu and Robinson, requires that institutions be transformed from extractive to inclusive, and this is not easy. It took what Chang (2002) described as the "long and winding road" of institutional development, which took "decades" in Western Europe. There is no evidence that Pakistan is turning a vicious circle into a virtuous one by creating those state institutions necessary to protect property rights, raise tax revenue, or pursue an effective industrial policy. The Global Competitiveness Reports compile various indices that proxy different aspects of governance; the indices range from 1 to 7 (7 being the best). Table 1 compares the reports from 2006/07 and 2014/15 and finds a widespread deterioration in state capacity, across the quality of institutions, favoritism in government decision making, wastefulness in government spending, and low and stagnant measures of the reliability of the police.

Table 1: Declining state capacity in India and Pakistan

Measure of governance	2006/07	2014/15
Quality of institutions	3.5	3.2
Favoritism shown in decisions of government officials	3.1	2.6
Wastefulness of government spending	3.5	2.6
Reliability of police	3.1	3.1

Source: World Economic Forum (2006, 2014).

Industrial policy worked in South Korea because it had a "developmental state." A developmental state is defined as one "whose politics have concentrated sufficient power, autonomy and capacity at the center to shape, pursue and encourage the achievement of explicit

development objectives, whether by establishing and promoting the conditions and direction of economic growth, or by organizing it directly, or by a varying combination of both" (Leftwich, 1995, p. 401).

The following components determine these political pre-conditions: (i) a small elite of developmentally-determined senior politicians, (ii) autonomy of the state from special interest groups, (iii) a competent bureaucracy insulated from the demands of politics, (iv) a weak civil society/independence from international capital and rural interests, and (v) legitimacy given by the populace to a single-minded approach to economic growth (Leftwich, 1995). There is no prospect of a developmental state emerging in Pakistan and so any comparison with – and especially calls to emulate – South Korea are nonsensical.

Combined with the pessimistic views in this paper on the failure of trade liberalization and devaluation to boost exports is the finding of a strong relation between income growth in Pakistan and imports (Hasan & Khan, 1994; Atique & Ahmad, 2003; Shah & Majeed, 2014). Felipe, McCombie, and Naqvi (2009) find that GDP growth greater than 5 percent per annum is likely to lead to a surge in imports and a balance-of-payments crisis. Pakistan is indeed caught in a dilemma: the 7–8 percent growth necessary for poverty reduction and structural transformation will lead to an inevitable external crisis unless the rate of export growth can be significantly stepped up.

While there is much reason to be pessimistic, there is also some reason to hope. This paper is a big-picture companion piece to a more specific argument in McCartney (2014). This earlier paper made a case for a particular and targeted form of industrial policy to promote learning and upgrading in Pakistan's textiles industry. It argued optimistically that some factors commonly seen as hindering industrial policy – competition from China, the global rules of globalization, global value chains, and the problems of energy and education in Pakistan – do need careful consideration, but are not insurmountable obstacles to industrial upgrading.

The study then went on to examine a very particular market failure that it argued policy intervention could usefully focus on – that of the risk and uncertainty associated with acquiring and learning to use new technology. The paper was careful to draw its policy lessons from an example that provides a realistic and practical option for Pakistan to emulate – not South Korea or India, but instead Bangladesh. This lesson showed that rapid and sustainable export growth in textiles can be achieved even in an economy with weak, corrupt, and unstable governance.

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