Financial Liberalization, Economic Growth, and Capital Flight: The Case of Pakistan Economy

Ma Degong, Raza Ullah, Farid Ullah, and Shahid Mehmood

1 Introduction

The McKinnon-Shaw hypothesizes that suppressive financial market regulations distort savers and investors incentives. Thus, financial deregulation and liberalization is a policy prescription for economic growth and development in a country. Historically, the early era after independence in 1947 was quite deterministic of its economic policy. Different financial and economic institutions were developed during that period, for instance, central bank, i.e., State Bank of Pakistan and Central Planning Board. In 1958, President General Ayub Khan initiated financial liberalization and also inculcated it in the 1962 constitution. He introduced economic freedom as a state policy. Besides, the economic fruit of financial liberalization, a public debate emerged and politicized the whole process regarding the inequitable distribution of wealth, income, and concentration of economic power in few hands. In policy circles, the talk was on forty big industrial groups in the country, who owned nearly half of the national industrial assets. Interestingly, the concentration was not only in industrial assets, rather eight out of nine major commercial banks control were also in the hands of such industrial state. The country's economic wizard at the time Dr. Mahbub ul Haq, the chief economist of the Planning Commission of Pakistan confirmed the little benefit of national industrial largesse

M. Degong · F. Ullah (✉)
School of Economics, Sichuan University, Chengdu, China
e-mail: madg@scu.edu.cn

R. Ullah
Department of Management Sciences, Islamia College University Peshawar, Peshawar, Pakistan
e-mail: Raza@icp.edu.pk

S. Mehmood
Freelance Economy Consultant, Islamabad, Pakistan

M. Shahbaz et al. (eds.), *Economic Growth and Financial Development*,
https://doi.org/10.1007/978-3-030-79003-5_7

on a common man life. He coined the term of twenty-two industrial families which then made a huge politico-economic impact on Pakistani society. Dr. Mehboob Ul Haq suggested state intervention essential in such economic conditions to correct the situation created by the liberalization policy of Ayyub government.

The post-1971 cessation war of Pakistan's eastern wing put the country on a difficult economic trajectory, which led to Bhutto's populist economic policy of nationalization program. The program nationalized major private national economic assets. Resultantly, in the aftermath of the nationalization program, government investments grew under the five years plan and resulted in the public sector expansion. The policy curbed a liberalized private sector investment. In 1977, the military government of General Zia again took over, ousting pro-socialist Bhutto's government. He initiated two-pronged economic policies including liberalization, and Islamization of economy. General Zia's government policy led to industrial liberalization but financial sector remained in the government ambit. This policy resulted in the private sector expansion to the extent of 44% in 1989. Zia promoted liberalization under the flag of Islamization. Economic liberalization policy was the major pillar of Nawaz Sharif's government economic policy in 1990s. He promoted privatization, deregulation, and liberalization policies keeping in view the experiences of Asian Tigers Malaysia, Korea, Japan, etc. The policy promoted foreign investment, liberalization of foreign exchange, and credit subsidies were cut down to a larger extent, although, the weaker macroeconomic conditions limit the benefits of economic liberalization to the national economy. Pakistan's strategic geographic location created many problems for the national economy. For instance, the US Pressler amendment badly affected economic conditions in Pakistan and the liberalization of economy. The amendment slowed down economic freedom during 1993–1997. Government policy to adjust macroeconomic indicators failed to deliver and led to the era of high unemployment and deterioration of foreign exchange position during 1995, which resulted in the ouster of Benazir Bhutto government. The succeeding Nawaz Sharif government again relaunched aggressive privatization of the economic assets. In the aftermath of 1997, private sector grew while the public sector shrank to a level. Furthermore, due to the geostrategic situation in the region, Pakistan responded to Indian nuclear tests by conducting five such detonations. It invited international embargos; and consequently ouster of Nawaz government. The Shaukat Aziz government in 2000 continued with the liberalization program and privatized major SOEs, etc. The Aziz economic policies produced highest economic growth in terms of GDP up to 9 percent. Regardless of the liberal policies in successive governments, capital mobility remained restricted during these eras.

In Pakistan, capital flight became a political flashpoint after the famous Panama papers in 2016 revealing 11.5 million documents and information about 150 politicians in fifty countries. Although, ownership and mobility are every citizen's right to their legally obtained capital. In many cases, the Panama leak was taken in a wrong direction whereas the legitimate offshore account should not be a matter of question. The presence of 200 names of Pakistanis created political ripples. Although, such generalization of massive funds outflow is not corruption or crime. Pakistan has a tight controlled regime for its citizen's foreign currency bank accounts ownership

Table 1 Pakistan's score

Categories	Score
Size of the Government	7.02 (10)
Legal Systems and Property Rights	3.63 (10)
Sound Money	6.67 (10)
Freedom to Trade Internationally	5.85(10)
Regulation	6.36 (10)

and capital control; besides, operating foreign currency account outside the country is also limited. This might be the result of the government's intention to discourage the flight of capital from Pakistan. Although, there are news on a daily basis of illegal capital flow from Pakistan mainly to Dubai. Pakistanis have invested hugely in Dubai's real estate business amounting to over 4 US billion $ tantamount to the Panama case. The existing regulations negatively affect Pakistani firms; for instance, containing acquisition of abroad assets unless allowed by the Economic Coordination Committee of the cabinet, which has dampened globalization of Pakistani businesses through international acquisition of assets.

This chapter will assess the foreign capital flight in the context of financial liberalization between 1972 and 2015 and its association with economic growth. The chapter will overview the evolution of Pakistan's exchange and trade control regimes during different phases. The chapter will offer specific policy recommendations based on these findings.

2 Overview of Economic Freedom in Pakistan

Canada's Fraser Institute publishes the "Economic Freedom of the World (EFW)" Index every year, ranking the countries according to the developments occurring in selected areas. There are five major areas, namely "Size of the Government," "Legal Systems and Property Rights," "Sound Money," "Freedom to Trade Internationally," and "Regulation." Within these five major categories are 24 subcategories, which contain further subcategories. The final ranking bifurcates countries in four quartiles, from "Most Free" to "Least Free." Suffice to say, EFW evaluation gauges how free are the citizens of a country in terms of carrying out mutually beneficial economic transactions, and overall, how free is a country's economy. In short, Pakistan does not fare well in terms of economic freedom. According to the latest available rankings (2019) based on the 2017 data, Pakistan ranks a lowly 136 out of the 162 countries evaluated in the report.[1] It is categorized as "least free." Pakistan's score on the five major categories is reflected in Table 1.

As can be gauged from Table 1, Pakistan fares particularly poorly in terms of "Legal Systems and Property Rights," which is not a surprise for anybody even

[1] "Economic Freedom Index 2019."

Table 2 Pending cases in Pakistani courts

Institution	Pending cases
Supreme Court of Pakistan	41,239
Federal Shariat Court	191
Lahore High Court	169,887
High Court of Sindh	87,292
Peshawar High Court	32,060
High Court of Balochistan	5877
Islamabad High Court	16,075
District Judiciary, Punjab	1,078,188
District Judiciary, Sindh	105,558
District Judiciary, KPK	201,174
District Judiciary, Balochistan	13,395
District Judiciary, Islamabad	38,265
Total	1,789,201

slightly acquainted with Pakistan's legal system and the abysmal state of its property rights. Whether related to physical property or intellectual property, property rights need a robust legal system for protection. It is well established that secure property rights are a must for quality life and economic growth. Hernando De Soto's groundbreaking work[2] (2001) in this regard demonstrated this aspect even more succinctly. Yet, the situation on this front remains abysmal, if not outright terrible. Laws for protecting intellectual property rights are mostly limited to papers only. Cases pertaining to physical property's possession and its use remain stuck in court for generations without any resolution. This means that the physical property cannot be used for a mutually beneficial economic transaction, thus reflecting what De Soto (2000) termed as "dead capital." Its non-use, in turn, connotes a financial loss to its owner and the economy as a whole. Just to understand the gravity of this issue in Pakistan, it is perhaps pertinent to mention that in one particular case related to property ownership, a final decision was made in 2018 after remaining for 100 years in the different courts of Pakistan.[3]

The overall picture of the efficiency of the legal system remains even more abysmal, reflected in Table 2, which gives the number of pending cases in various Pakistani courts as of end-August 2019.[4] With 1.7 million cases pending in the courts, with a substantial portion in terms of cases that have been pending for a considerable time, it is quite apparent that Pakistan has a legal system that fails to provide the required legal cover that can protect economic freedom as well as propel economic activity. A similar picture of inefficiency is reflected in other indicators. When we consider the size of the government as an indicator, there are no two views that Pakistan's state apparatus at every level (federal, provincial, and district) is

[2]"The Mystery of Capital."

[3]"Justice delivered? Supreme Court passes ruling on 100 year old case."

[4]Data obtained from Law & Justice Commission of Pakistan.

predatory and extractive in its nature and functioning.[5] The taxation system of Pakistan is perhaps an apt indicator of this reality, with an estimated 37 government agencies administering and collecting 70 different types of taxes.[6] It is almost incomprehensible that a conducive business environment can be created with such a large number of taxes, administered by a government apparatus beset with inefficiencies and corruption (Bukhari, 2019).

One outcome of this can be seen in large government footprint in the economic affairs, which tend to retard the process of open and beneficial exchange. The major portion of Pakistan's economy (as measured by growth in GDP) comes from government expenditures, which is a sign of unproductive form of growth.[7] This dominant footprint of the government, though, comes at a substantial cost in various forms. One cost is reflected in the mismanagement of resources due to corrupt practices. For example, the Federal Audit report for the Fiscal Year 2015–2016 estimated mismanagement/corruption in Public Sector Entities (PSEs) to the tune of Rs. 852 billion.[8] Similarly, $18 billion or more are reported under corrupt government procurement practices that have an estimated size of $60 billion per year.[9] Thus, the large size of the government results in allocative inefficiencies of capital besides harming the chances of mutually beneficial economic transactions that can spur sustained economic growth. Empirical studies have born out over time.[10] Yet, Pakistan's government keeps expanding at the expense of domestic economic liberties. Other indicators, besides the above two, show a similarly dismal picture. When it comes to "sound money,"[11] it is hard to justify Pakistan's currency as constituting sound money. Inflation by now has galloped to more than 10 percent in 2019, spurred by multiple raises in utilities prices that have given vent to inflationary momentum in almost all items of use. The domestic currency has seen a precipitous decline in its value against other currencies, something that is expected to persist in the coming years. When it comes to opening foreign currency accounts, the atmosphere is such that foreign currency accounts are now one of the most suspicious items in lexicon of federal investigation and tax agencies. This is especially excruciating for traders who have to open foreign currency accounts for carrying cross-border, external trade.

Closely linked to this issue is the criterion of "freedom to trade internationally." Again, if one were to go through the various criteria of this indicator, Pakistan does

[5]"The long remonstrance: Pakistan's receding writ of the state in light of federal law and order commission report of 1993."

[6]"Tax reforms with borrowed funds."

[7]See, for example, various Annual reports of the State Bank of Pakistan (SBP).

[8]"Rs. 852 billion corruption in public sector entities exposed."

[9]"$60 billion"

[10]For example, see "An analysis of the impact of the government size on economic growth of Pakistan: An endogenous growth."

[11]Sub-components of sound money include money growth, freedom to hold foreign currency accounts, inflation and deviation from inflation.

not find itself in a good position. They have been elevated markedly in order to lower the quantum of imports, directly and indirectly affecting the quality of life of domestic residents. And if we come to "regulation," it would suffice to say that Pakistan's economy is a highly regulated, an indirect outcome of the large footprint of government in economic affairs.

3 Linkages of Economic Growth to Economic Freedom

When Adam Smith wrote his magnum opus, The Wealth of Nations (1776), it was a time when nation-states in Europe were gradually rising to the realization that two centuries of mercantilist[12] policies had perverse outcomes for the economy. Smith was the first, and foremost, among a small array of writers who advocated a more liberal approach toward economic management. In one of the celebrated passages of his book, he opined that in order to enhance economic growth and make a nation wealthy, little else is required than easy taxation and tolerable administration of justice. Both of these are directly and indirectly linked with the freedom to engage in economic and financial transactions, and provision of a legal cover to protect people's liberties in their quest to enhance their wellbeing through free, mutually beneficial exchange. Smith's maxim, it appears, has stood the test of time very well. By now, there is ample evidence (anecdotal and institutional research) to suggest that economic freedom and economic growth are positively correlated with each other. The literature supporting this notion is vast. For this chapter, it would suffice to give few examples.

Julio Cole (2003) studied the robustness of this conjecture through estimates based on long-term data.[13] Despite tweaking the methodology as per his criticism of traditional economic freedom index and running the new one on different models of economic growth, he still concluded that there indeed existed a strong link between economic freedom and economic growth. Campbell and Rogers (2007) looked at the instance of business formation in the context of economic freedom and found that net business formation has a positive relation with economic freedom.[14] Carlsson and Lundstrom (2002) decomposed the economic freedom index into smaller measures in order to find out whether the decomposition and addition of few more measurement variables can challenge the notion of economic freedom being important to economic growth. Despite introducing of new variables in measurement and decomposing the measurement variables into smaller segments, they still found a robust relationship between economic freedom and economic growth.[15] De Haan and

[12]Mercantilism, as an economic policy, had large government economic footprint and advocated heavy regulation of economic activity, especially commercial and financial aspects of the economy.

[13]"The contribution of economic freedom to world economic growth, 1980–1999."

[14]"Economic freedom and net business formation."

[15]"Economic freedom and growth: decomposing the effects."

Sturm (2000) compared various economic freedom indicators in order to gauge whether the results are the same or differ sizeable according to the methodology used. Their research concluded that no matter which indicator is used, economic freedom does foster economic growth.[16]

Similarly, Hernando De Soto's excellent work on property rights was mentioned in the lines stated above. In one of his written pieces (2001),[17] he and his colleagues estimated $9.3 trillion of "dead capital" around the globe. It probably would not have been the case if Smith's advice of tolerable justice dispensation had been followed, accompanied by facilitation of such institutional mechanisms that would have ensured disposal of this dead capital in economic transactions. In essence, it appears that despite different freedom indices serving as measures of economic freedom, there is sufficient evidence to prove that economic freedom does matter for economic growth.

4 The Political Economy of Financial Liberalization

The antecedents of modern financial system and financial liberalization can be traced back to the late nineteenth and early twentieth centuries. The decisions are taken then had a notable impact upon various economic variables (like flow of finances and income generation within economies). It would, thus, be of interest to briefly go through the political economy behind these decisions since it can not only give us a glimpse into what propelled financial policies at that time, but also guide us toward the important components of this debate that may shape future policies, both around the globe and in Pakistan. The time between 1870 and 1914, is known as the first era of globalization, saw relatively free movement of capital and financial resources across the borders. In 1919, when the end of WWI and its aftermath had brought about the end of the era of free capital movements, John Maynard Keynes (1919) reminisced about the time when an "unsuspecting" Londoner would decide where in the globe to venture his finances without the need for being physically present, while sharing the fruits of his investments. Perhaps more importantly, Keynes stated that he would have been much aggrieved at the slightest interference, reflecting that pre-war era was one of unfettered financial movements across borders.[18] It was perhaps a sign of times and changing mood toward unfettered global financial movements that the same Keynes supported restrictions upon such flows in his seminal work (1936),[19] in the aftermath of the Great Depression in 1929. A 1938

[16] "On the relationship between economic growth and economic freedom."

[17] "The Mystery of Capital," Finance and Development, IMF.

[18] "Globalization of Finance: A historical view," p. 134.

[19] "The General theory of employment, interest and money." Keynes advocated finances to remain "national" rather than global.

study carried out under the aegis of the League of Nations tried to gauge financial integration and openness among nations by grouping countries into three specific groups (Obstfeld and Taylor, 2004).[20] It concluded that financial openness and integration were indeed the highest before WWI but saw a significant decline after that. Even the advent of Bretton Woods and its end, heralding in a time of independent central banks pursuing policies without pegs, could not reverse this trend with studies suggesting that capital mobility has never attained on a *de jure* basis, levels seen before WWI.[21]

What were the factors that became the basis of the above-described developments? The growth and ebb in capital flows and financial integration are closely interlinked with the debate surrounding *capital controls*. The main arguments in the debate upon capital controls are the *political economy* and the *second-best* arguments. It is the political economy argument that is of interest to us for this research effort. In terms of political economy of financial liberalization, one can use Quinn and Inclan's (1997)[22] distinction between "Partisan Effects" and "Macro Policy Effects." Partisan effects analyze the reaction of various groups within a country to financial openness, particularly if they feel that such an integration would end up hurting their financial prospects or their hold upon a certain trade (a monopoly or an oligopoly). These effects extend the Stopler-Samuelson theorem of international trade, which discusses the possible implications of flow of unfettered cross-border homogenous resources on relative prices in home country. Put another way, this effect gauges the distributional consequences of financial integration using the Stopler-Samuelson theorem. Such effects directly interact with the structure of the economy. In contrast, macro policy effects relate to distributional implications of a government's policy on different groups rather than direct interaction with structure of the economy and any change in it. For example, Alesina and Tabellini (1989) presented a model[23] where two major groups of the economy (workers and capitalists) compete in terms of resource extraction and lessening the tax burden upon their group. The basis of this competition is consumption smoothing and resource optimization. Other models also discuss the implications and methodology along the same lines. In Pakistan's context, its economic history is rife with controversies over who is benefitting from the economic policies of successive governments. Put another way, the implications of Alesina and Tabellini's model, and macro effects aspect, fits Pakistan pretty well. The financial repression of the 1950s and the 1970s (through state-administered rates and nationalization of financial institutions, respectively) were carried out mainly under the pretext of wealth concentration in a small group of businessmen/industrialists, and to direct capital toward politically favored industries. In contrast, a major portion of 1960s and 1990s were devoted to deregulation policies. The context was the urge to foster private wealth accumulation and

[20]"Global capital markets: integration, crisis, and growth."

[21]"The political economy of global financial liberalization in historic perspective," p. 5.

[22]"The origins of financial openness: A study of current and capital account liberalization."

[23]"External debt, capital flight, and political risk."

enhanced domestic investment by the private sector. From the 1990s onward, though, there seems to have been a consensus among policymakers that a comparatively liberal financial regime is the preferred route, with interventions taking place through managed fiscal and monetary policies ("managed" exchange rate). There is, no shortage of critics of such policies who believe that they are exploitative in nature. For example, former State Bank of Pakistan (SBP) governor Dr. Yaqub Khan strongly criticized non-public, liberalized banking system since he believed it adversely affects small level savers and depositors (Khan, 1999).[24] A particular area of concern for such critics has been the wide disparity between what savers/ depositors get in return and what banks earn by investing the same money in high-yielding, less risky investments like government treasuries (this difference is termed as the "spread"), a situation that has been prevalent since the deregulation/de-nationalization drive of the early 1990s. Such an adverse distribution of gains, critics argue, has negative implications for the society, with major chunk of gains accruing to the financial elite who constitute a minute group of Pakistan's overall population.[25]

The question of who gained or who lost through pursuing a comparatively liberalized financial policy is still a matter of debate and research, with opinions divided on the efficacy of pursuing such a policy in Pakistan. But there is unanimous agreement among researchers and analysts that whichever policy a particular government follows in this regard, it is ultimately based primarily on political motives rather than purely cost-benefit considerations.

5 Evolution of Pakistan's Exchange and Trade Controls

The history of Pakistan's exchange and trade controls is lit with innumerable policy changes and frequent "adjustments" made specifically to address the deficits in its Current Account (CA). Some of the distinct characteristics of the policies pursued since independence are:

(a) Managed exchange rate policies which are driven mainly by CA and export promotion considerations rather than open market valuation. Till the 1970s, a "Foreign Exchange Committee" of Finance division called the shots in this regard, until the advent of a more independent Central bank that has been closely coordinating with the government to determine exchange rates.
(b) Resorting frequently to tariff and nontariff barriers to compress imports as trade deficits widened. Till the 1960s, at least, the favored go-to policy was import licensing. Since then, the policy to limit imports mainly revolves around "import compression" through higher tariffs and other taxes on imports.

[24]"Dr. Yaqub says banking system exploitative, inefficient and corrupt."

[25]For example, see "The curious case of a bank CEOs salary."

(c) Incentivizing exports through publicly financed subsidies. The quantum of subsidies has varied over time but has largely been directed toward textiles sector, which has maintained its position as the largest component of Pakistan's exports.
(d) The use of both tariff and nontariff barriers to shield the domestic industry from competition. It started with the "infant industry" argument but has carried on ever since.
(e) Government relied on government controlled domestic commerce rather than commerce based on market-based, free transactions with limited government interference.

In short, cumulatively, these policies are thought to have caused more damage than impart advantages upon Pakistan's economy. For example, provinces still cannot price their natural resources on market rates despite the passage of the 18th Amendment which gives provinces more autonomy. The prices of natural resources are still centrally controlled, which has led to some provinces like Balochistan being denied trillions of rupees (Bengali, 2018).[26] Similarly, the infant industry argument has been exploited mercilessly by local industrialists to preserve their monopolistic hold on sectors and stave off competition. From 1947 to 1951–52, trade and exchange policies were comparatively liberalized as Pakistan enjoyed surplus CA, mainly driven by high demand for cotton due to Korean War. But as the war ended and demand fell drastically leading to CA deficits, policy for the remaining decade changed completely. The fifties were marked by stringent "direct" controls on trade and exchange rates. The main purpose was to limit imports as much as possible while encouraging exports through a devalued rupee, a policy that seems to find wide favor among Pakistani policymakers over time (continuing to the present). Imports were strictly regulated through licenses, and so were new investments in industrial sectors. Capital was incentivized to be diverted to selected industries. As per government's assessment such a policy may contribute to a rise in exports. Even within the country, government would resort to strict price controls on domestically produced goods, akin to an indirect intervention in domestic commerce. Later studies and analyses looked upon these as inefficient methods of running economic management.[27]

The stringent trade and exchange rate controls were deregulated to a large extent in the Ayub Khan era, which many terms the "golden growth era" of Pakistan. Price controls and restrictions on profit margins were largely done away, and a liberal trade regime was followed with fewer restrictions upon imports. However, an overvalued exchange rate was maintained through government intervention, ostensibly to help

[26]Dr. Kaiser Bengali, former advisor NFC to government of Baluchistan, has estimated that from 1955 to 2014, Baluchistan had to bear cost equaling Rs 7.69 trillion under centrally administered subsidy schemes despite the fact that it provided major portion of natural gas to the whole country until at least mid-1990s. Its pertinent to mention that Baluchistan got its first natural gas connection in 1982. See "A cry for justice: Empirical insights from Baluchistan."

[27]"The management of Pakistan's economy: 1947–1982."

importers import latest capital equipment (like machinery and raw material). Import licensing was abolished, and by 1964, quite a few items could be imported without government permission. There was a marked pro-industrial bias as there were low interest loans, tax concessions such as tax holidays and accelerated depreciation allowances. Studies (for example, Janjua, 2007) that look at post-1971 instances of exchange and trade controls[28] normally assume four distinct phases in this regard, which are as follows.

5.1 Phase I (1972–1981): Fixed Exchange Rate Regime and Partial Lifting of Trade Controls

Pakistan adopted a fixed exchange rate policy during this period. Pakistani currency was devalued by 56 percent in 1972, followed by an 11 percent appreciation in 1973. This fixed exchange rate policy was maintained till 1982. Capital and current accounts remained substantially restricted during this phase. While the currency was devalued, trade control system was revived mainly on the recommendations of the International Monetary Fund (IMF). The export bonus scheme was abolished along with all kinds of export subsidies except for tax rebates and export financing. Tariffs were reduced on intermediate and capital goods. In addition to these, the import licensing system was also simplified.

5.2 Phase II (1982–1998): Managed Floating Exchange Rate and Liberalization Initiatives

The government adopted a managed floating exchange rate in 1982 and linked the currency to a basket of 16 currencies (major trading partners). The currency value started declining since then. In 1991, some new measures to reform the exchange and payments system were introduced that include: (i) resident Pakistanis were allowed to maintain foreign currency accounts like nonresidents; (ii) restrictions on holding of foreign currency and on foreign exchange allowances for travel were removed; and (iii) rules governing private sector's foreign borrowing were liberalized. During this phase, import tariffs were significantly reduced from 350 percent in 1982 to 45 percent in 1998. Import licensing was eliminated with a few exceptions, and nontariff barriers were reduced considerably. New export promotion measures were also introduced regarding bonded warehousing and export credit, textile export quotas, quality control, marketing, and training of skilled manpower.

[28]"Pakistan's external trade: Does exchange rate misalignment matter for Pakistan?" and "Perspectives on Pakistan's trade and development."

5.3 Phase III (July 1998–July 2000): Multiple Exchange Rate and Dirty Float Regimes

This phase was marked with political instability leading to erosion of the private sector's confidence. Whatever liberalization achieved on current and capital accounts in the earlier periods was virtually reversed. The system of multiple exchange rates was adopted, consisting of an official rate (pegged to US dollar), a floating inter-bank rate (FIBR), and a composite rate (combining official and FIBR rates). From 1999 to 2000, dirty floating exchange rate was adopted, and MER system was removed. Despite economic and political problems, Pakistan managed to continue with market-based reforms, including liberal policies for imports and foreign investment.

5.4 Phase IV (July 2000–2009): Flexible Exchange Rate Regime and Trade Liberalization

Since 2000, Pakistan is following a flexible exchange rate regime with minimal FX control and restrictions. Central bank's role in this exchange rate regime was limited to the extent of preventing excessive fluctuations in exchange rate. Tariff rates were reduced across the board, direct state interventions and quantitative restrictions were largely reduced. Between 2003 and 2007, the maximum tariff rate was 25 percent. However, due to rising trade deficit, the maximum tariff was raised to 35 percent since 2008. Quantitative restrictions and other direct state interventions into trade along with Statutory Regulatory Orders (SROs), previously used to discriminate firms and industries were drastically reduced, thus making the trade regime fairly simple. Rapid Export Growth Strategy (REGS), introduced in 2005, was aimed to reduce the cost of doing business in Pakistan, upgrade skills and technology, comply with social and environmental concerns, encourage and strengthen trade promotion bodies, higher value-added exports, and export market diversification.

6 The Aftermath of Nationalization Policy of Bhutto Era

When the Pakistan Peoples Party (PPP) assumed power in December 1971 after the country's dismemberment into eastern and western parts, it embarked on a massive nationalization in all spheres of the economy that was to have a lasting repercussion upon Pakistan's economic trajectory. The large-scale drive to nationalize economic assets owed to the firmly held impression of 22 families having the major portion of

Pakistan's wealth within their grasp.[29] The PPs answer to address this monopolistic hold, redistribute wealth and carry out management according to their belief in "Islamic-Socialism" was to carry out wholesale nationalization under the "Nationalization and Economic Reforms Order" (NERO). It began with nationalization of 31 industrial units, predominantly the capital and intermediate goods industry. In this second phase of nationalization, 13 major banks, more than a dozen insurance companies, two petroleum companies, and ten shipping companies were nationalized. The third, and the last phase, culminated in the nationalization of over 2000 cotton, ginning, and rice husking units. Moreover, to expand such a massive nationalization effort, the public sector saw substantial expansion in scope and employment. There are no two views in terms of the nationalization program proving to be a disaster for a long time to come. The only difference of opinion remains upon the severity of the negative effects! As early as 1973, the US government had recognized the negative repercussions of such a program by pointing out lack of private investment and initiatives for the private sector, rising food grain prices (partly due to higher support prices), increasing budgetary deficits (resulting in negative savings), substantial rise in nondevelopment spending, and rising foreign debt obligations.[30] Most of Pakistan's major investors, especially in the industrial sector, did not invest again in Pakistan for a very long time.[31] Amjad and Ahmed (1984), while critically assessing the economic performance under Bhutto, observed that socioeconomic programs were overambitious plus costly for the country to afford, notable failures in the industrial and agricultural sectors, failure to generate additional employment, failure of agricultural sector to perform despite massive government help, stagflation (high inflation and higher unemployment), and long-gestation programs, etc.[32]

Even if looked in terms of a longer time horizon to judge the fallout from nationalization policies, there is no doubt that the said policy left a legacy of unending economic problems. Arguably the most well documented of these is the burden to Public Sector Entities (PSEs) on Pakistan's economy. Heavily overstaffed, under substantial debt burden and unionized, the governments after 1977 have failed in convincing the private sector to buy these entities. A clear reflection of their burden upon Pakistan comes in the form of their total debt (domestic plus external). By September 30th, 2019, the end of first quarter of 2019, the domestic debt of PSEs stood at approximately Rs. 1.4 trillion, and external debt stood at approximately $

[29]This concept of 22 families controlling Pakistan's wealth was made famous by Dr. Mahbub ul Haq in his capacity as Chief Economist of the Planning Commission, in 1968. As per his calculation, these 22 families controlled 66 percent of the industry and 87 percent of country's banking and insurance industry. See, for example, "People who own greatest amount of wealth."

[30]"Pakistan: The economy under Bhutto." The list of 31 key industries nationalized during this time is given, plus the experiences of some major investor are recounted.

[31]"Impact of nationalization on Pakistan's economic development."

[32]"The management of Pakistan's economy: 1947–1982," p. 98.

3.9 billion.[33] Zahoor and Asif[34] (2018) lamented nationalization policy under Bhutto, terming it "Fabian socialist reforms" which made the economic structure a bureaucratic quagmire. Rammal (2008) studied[35] of Pakistan's nationalized banks under the Bhutto regime, and found that the decision was based purely on political grounds. The banking sector's inefficiencies kept increasing until the 1990s, when majority of them were finally privatized under Nawaz Sharif's government. Ahmad and Hussain (2012), in their study carried out on the industrial policies of various governments,[36] opined that nationalization along with policies of other governments (like higher tariffs to discourage imports and protect local industries) have led to a gradual decline of Pakistan's industry but also its non-competitiveness over time. Similarly, Ali and Malik (2009) opined that the confidence lost by businessmen due to nationalization has never managed to return to Pakistan's economy.[37] It can be safely concluded that majority of the research, if not all, shows that nationalization under Bhutto has negative repercussions that still reverberate in one form or another through the economic sphere.

7 Globalization of Pakistani Business Firms and Its Impediments

Globalization is a multifaceted phenomenon where some people focus on its economic and political impacts while others are concerned with the globalization's social and cultural footprints. This chapter will focus on the economic aspect of the globalization on businesses in Pakistan. Economic globalization can be defined as "unity of market, labor, production market, money and capital." Economic globalization has helped countries expand their market size in the form of export and foreign capital accumulation, which aids development. It provides competition within the industry which results in a variety of products at lower prices and an improved standard of living. Like many developing countries, Pakistan liberalized its economy in realization of the fact that globalization is imperative to growth as Late Dr. Mahbub-ul-Haq has rightly said that "Globalization is no longer an option, it is a fact. Developing countries have either to learn to manage it far more skillfully, or simply drown in the global cross currents."[38] Globalization in Pakistan did not bear the same fruits as some fast globalizers like India and China. The anti-capitalist sentiments and propaganda over the past few years had highlighted the possible negative aspects of globalization (that these gains will only benefit the rich

[33]Figures taken from State Bank of Pakistan (SBP).

[34]"Political and economic dimensions of nationalization of industries under Zulfikar Ali Bhutto."

[35]"Political motivations: The nationalization of the Pakistani banking sector."

[36]"Experiments with industrial policy: The case of Pakistan."

[37]"The political economy of Industrial development in Pakistan: A long-term perspective."

[38]"Corporate Globalization and Challenges for Pakistani Companies."

and MNCs) (Husain, 2001).[39] Moreover, Pakistan's manufacturing and export units, have not kept pace with that of the rest of the world. However, there is a lot of untapped potential and opportunities toward globalization for Pakistani businesses. A brief account of the available opportunities is as follows:

Agriculture With the new WTO development rounds, subsidies and support for agricultural products are hopefully removed enabling Pakistan to capture a chunk of global commodity markets, especially in close proximity. Moreover, with the agricultural trade liberalization regime in Pakistan, tariffs and quantitative restrictions have also been removed to facilitate the trade of agricultural products.

Trade The recent reforms and market-determined exchange rate have facilitated competitive and efficient industries in which Pakistan has a comparative advantage. Except for a few items, the export of all goods is allowed. The gains from trade in services can be as huge as that of merchandise goods. The general agreement on trade in services has liberalized this sector and many developing countries have benefitted from this sector. Pakistan has not been able to take advantage of this dynamic sector as yet.

The challenges toward business globalization can be broadly classified into four categories:

Companies' Competitive Strength Competitive strengths or capacity building in all the functional areas of business enable companies to build competitive edges pertaining to technology, quality, cost, and control over operations. The firms operating and expanding globally need to transfer their human and financial capital abroad and build relationship with buyers and suppliers. The Pakistani companies that are expanding overseas go global on their own, i.e., on their learning and experience curve, technical and financial competencies, and international linkages and the capacity to meet the standards prevailing abroad. A very serious difficulty in global expansion of Pakistani firms has been a problem of low, uneven, and inconsistent quality of products. Although many firms have obtained ISO 9000 certification, yet many are still striving to achieve this quality standard.

Institutional Support Framework The public/private institutional support for technical and financial capacity building is vital for corporate globalization. This support originates from trade policy incentives of government pertaining to foreign trade. It provides enabling environment to companies with the potential of global expansion. Unfortunately, such support is non-existent from public bodies. Globally expanding companies and individual exporters are complainant of their long-awaited pending claims owing to volatile and unfriendly policies executed by the public sector. Pakistani market lacks highly competitive, strong, and efficient financial institutions which can take a lead in exports of their services resulting in negligence of a much dynamic sector of trade in services.

[39] "How is Pakistan Positioning Itself for Challenges of Globalization" and "Internationalization of SMEs in Pakistan: A brief theoretical overview of controlling factors."

Foreign Regulations Governing Businesses Foreign regulations governing businesses also influence such as Labor laws, environmental safety, consumer rights, fair trade practices, international codes like International Labor Organization (ILO), United Nations Conference on Trade and Development (UNCTAD), and Organization for Economic Cooperation and Development (OECD) for businesses.

Cultural/Social Perceptions The anti-capitalist sentiment, protests, and rhetoric in the past few years have helped focus on the negative aspects of globalization within Pakistan. On the international front intense competition, unknown culture and customer behavior, cost of marketing and business research, quality, hygiene, the perceived risks of failures, and changing environment.

8 Financial Liberalization and Economic Growth: Pakistan's Case

The case for financial liberalization to spur economic growth has gained momentum over the decades after various studies emphasized upon the openness of financial sector. In the nineteenth century, Walter Bagehot revolutionized the writings on financial sector and its role in the economy. His 1873 book[40] was arguably the first modern, complete description of the workings of the global financial sector, detailing the role of money markets in the global economy and the importance of this sector for the overall economic activity. Schumpeter (1934) and Joan Robinson (1952) are some of the well-known, early writers who wrote on the financial sector's effect on economic growth. Schumpeter, for example, thought that the role of financial intermediaries is of critical importance in economic growth since they help bridge the disconnect between savers and investors, thus enabling more loanable savings and hence increasing the likelihood of increased finances spurring economic growth. After WWII financial liberalization became an important aspect of studies on the effects of financial sector openness on economic growth. The basic argument underlying the push for financial transparency was the perceived increase in the productivity of capital that in turn affects aggregate economic outcomes. Like the famous Evsey-Domar model of economic growth, several models emphasized the critical role that savings play in the process of economic growth, something that Schumpeter had alluded to in his writings. It was argued that in an atmosphere where financial markets are repressed by too many regulations, the use and allocation of capital are less than productive. Moreover, such repression has negative repercussions for savings, financial intermediation, depth and growth of primary and secondary financial markets (financial deepening), etc.

There have been numerous studies on the various aspects of financial sector and financial liberalization on economic growth in Pakistan's case. These studies can be

[40]"Lombard Street: A description of the money market."

divided into studies that cover shorter and longer time spans. Suffice to say that the studies reach differing conclusions, based on the variables, aspects, criteria, and methodology used. Some of these are stated in the following lines. Khan and Qayyum (2007) undertook a study involving long-term data (1961–2005) on trade and financial sectors.[41] Although their results indicated a positive impact of trade and financial liberalization on economic growth, the effect of financial liberalization on economic growth in the short run was negative. Awan et al. (2010), instead of looking at the impact of financial liberalization upon different variables, tried to gauge the effects of changes in real interest rate on financial liberalization and other variables.[42] Their findings suggest that real interest rates positively correlate with financial liberalization in Pakistan, which in turn tends to have positive effects upon accumulation of savings. Munir et al. (2013) undertook empirical testing of the link between Pakistan's financial liberalization and economic growth. Using long-term data from 1972 to 2010, their research concluded a positive correlation between financial liberalization and economic growth.[43] They further contend that the low level of savings and economic growth rates till the early 1990s and later on were the result of restrictive financial liberalization policies pursued earlier. Samina Shabbir (2013) undertook a study of financial liberalization in Pakistan and its effects upon economic growth in Pakistan[44] using component analysis (Naveed and Mahmood, 2019). She bifurcated the impact by its domestic and external components, and found that both the domestic and the external components of financial liberalization (if measured *de jure*) have a positive impact upon economic growth in Pakistan.

9 Discussion and Recommendations

In light of the above-stated discussion, it would perhaps be safe to state that the link between financial liberalization and economic growth in Pakistan is still debated. However, a major portion of research points to positive links between the two. Especially controversial/debatable are the distributional issues surrounding financial liberalization, an aspect upon which there is scant quality research. It is argued that most of the studies in the context of financial liberalization and its related issues tend to miss a few important variables of consideration, which calls for tweaking future studies in a manner that covers these aspects so that a more nuanced, authentic picture on this issue could emerge. The first important variable/aspect that majority of these studies ignore is the issue of *Trust*. Put another way, Pakistan lacks

[41] "Trade, financial and growth nexus in Pakistan."

[42] "Rate of Interest, financial liberalization and domestic saving behavior in Pakistan."

[43] "Financial liberalization and economic growth in Pakistan: Empirical evidence from co-integration analyses."

[44] "Financial Liberalization and its impact on Economic Growth of Pakistan" and "Competitive environment in banking industry: Evidence from an emerging economy."

credibility in terms of its policies, which imparts a negative image upon the country, thus limiting chances of foreign investment coming in. And it is not just the foreign investment that is a victim of negative perceptions about the country, but domestic financial flows towards economic activities also become retarded. This aspect and its implications (both long-term and short-term) are yet to be appropriately analyzed through studies.

The examples are many, demonstrating credibility in terms of Pakistan's chances of attracting financial flows. There were, for example, long-term repercussions for Pakistan when it froze foreign currency accounts in the aftermath of nuclear explosions in 1998. It dealt a severe blow to the foreign investors' confidence and perception about their investment in Pakistan. But there is yet to appear a study that can estimate the damage in terms of financial inflows. More recently, the financial penalties imposed upon Pakistan in the Reko Dek and Karkay rental power case has again sent a negative vibe through financial markets about Pakistan that will hurt its chances of attracting significant financial inflows. Critics of the hypothesis stated in the above paragraph, especially in the existing scheme of things, would immediately point out the recent uptick in financial inflows to Pakistan and the fact that the CPEC is a $60 billion venture under which Pakistan received significant financial inflows as negating the issue of Pakistan's less than stable perception. But such arguments are misdirected in the sense that they do not take quality and nature of these flows into consideration (as do most studies). The uptick in financial inflows is largely characterized by portfolio investment ("hot money"), chasing the considerable arbitrage opportunities arising out of an enormous difference of 11 percent between discount rates in Pakistan and globally (also called as "carry trade"). The other way of saying this is that these kinds of inflows are not brick and mortar, long-term investment that leads to job creation, thus feeding into GDP growth. Instead, these are short-term, volatile inflows that can be pulled out at a moment's notice. Also, the inflows under the CPEC to a large extent government-to-government arrangements rather than led by private sector participants. Suffice to say that this kind of arrangement does not in consonance with the aim of economic freedom, which envisions a minor role of the government in economic affairs.

A third and equally important aspect of the debate regarding financial liberalization and economic growth in Pakistan is the monopolistic structure dominating the financial sector in Pakistan, especially the big banks. This fact has been established beyond doubt by now.[45] Yet, the impact of such an arrangement on the probability of financial inflows (especially foreign) has yet to be adequately gauged through studies. A sector characterized by monopolistic tendencies is highly unlikely to attract much investment. Given that the major source of profit of banks in Pakistan is an investment in government treasuries and that there is a wide spread of rate between the profit obtained and the one given to account holders, Pakistan's financial sector is by and large indulging in an adverse distribution of wealth (from populace to a group of individuals, i.e., financial industry) rather than helping

[45] See "Assessing nature of competition in banking sector of Pakistan."

propel economic growth. For any proper assessment of Pakistan's financial sector and its role in economic development, the factors discussed above will have to be considered in future studies, along with other variables that affect the outcomes in this sector.[46]

References

Ahmed, V., & Hussain, S. (2012). 'Experiments with industrial policy: The case of Pakistan'. *Sustainable Development Policy Institute (SDPI).*

Alesina, A., & Tabellini, G. (1989). External debt, capital flight and political risk. *Journal of International Economics, 27*(3–4), 199–220.

Ali, I., & Malik, A. (2009, September). The political economy of industrial development in Pakistan: A long-term perspective. *Lahore Journal of Economics, 14*, 29–50.

Amjad, R., & Ahmed, V. (1984). *The management of Pakistan's economy: 1947–82*. Oxford University Press.

Awan, R. U., Munir, R., Hussain, Z., & Sher, F. (2010). Rate of interest, financial liberalization & domestic savings behavior in Pakistan. *International Journal of Economics and Finance, 2*(4), 75.

Bengali, K. (2018). *A cry for justice: Empirical insights from Balochistan*. Oxford University Press.

Bukhari, H. (2019). Tax reforms with borrowed funds! *Business Recorder*.

Carlsson, F., & Lundström, S. (2002). Economic freedom and growth: Decomposing the effects. *Public Choice, 112*(3), 335–344.

Cole, J. H. (2003). Contribution of economic freedom to world economic growth, 1980–99. *Cato Journal, 23*, 189.

Compbell, N. D., & Rogers, T. M. (2007). Economic freedom and net business formation. *Cato Journal, 27*, 23.

De Haan, J., & Sturm, J. E. (2000). On the relationship between economic freedom and economic growth. *European Journal of Political Economy, 16*(2), 215–241.

De Soto, H. (2000). *The mystery of capital: Why capitalism triumphs in the West and fails everywhere else*. Civitas Books.

Husain, I. (2001). How is Pakistan positioning itself for challenges of globalization. *Mahbub ul Haq Human Development Review, 1*(2), 101–111.

International Monetary Fund (IMF, 2001). The mystery of capital. *Finance and Development*, March 2001, 38(1).

Janjua, M. A. (2007). Pakistan's external trade: Does exchange rate misalignment matter for Pakistan. *The Lahore Journal of Economics, 12*(1), 125–154.

Keynes, M. (1919). *The Economic consequences of the peace*. Macmillan & Co., Limited.

Keynes, J. M. (1936). *The general theory of employment, interest and money*. Palgrave and McMillan.

Khan, S. (1999). *Do World Bank and IMF policies work?* Springer.

Khan, M. A., & Qayyum, A. (2007). *Trade, financial and growth nexus in Pakistan* (No. 2007, 14). Economic Analysis Working Papers.

[46]For example, laws governing mergers of banks and prevention of monopolistic competition.

Munir, S., Chaudhry, I. S. and Akhtar, M. H. (2013). Financial liberalization and economic growth in Pakistan: Empirical evidence from co-integration analysis. *Pakistan Journal of Social Sciences (PJSS)*, *33*(2).

Naveed, S., & Mahmood, Z. (2019). Impact of domestic financial liberalization on economic growth in Pakistan. *Journal of Economic Policy Reform, 22*(1), 16–34.

Obstfeld, M., & Taylor, A. M. (2004). *Global capital markets: Integration, crisis, and growth*. Cambridge University Press.

Quinn, D. P., & Inclan, C. (1997). The origins of financial openness: A study of current and capital account liberalization. *American Journal of Political Science*, 771–813.

Rammal, H. G. (2008). Political motivations: The nationalization of the Pakistani banking sector. *Corporate Ownership and Control Journal, 6*(2), 342–346.

Robinson, J. (1952). *The Economic Journal, 62*(248), 925–928.

Schumpeter, J. A. (1934). *The theory of economic development*. Harvard University Press.

Shabir, S. (2013). Financial liberalization and its impact on economic growth of Pakistan. *Pakistan Institute of Development Economics (PIDE).*

Zahoor, M. A., & Asif, A. (2018). Political and economic dimensions of nationalization of industries under Zulfikar Ali Bhutto. *Pakistan Journal of History and Culture*, *39*(2).