Chapter 8
Does Financial Liberalization and Trade Openness Promote Growth in South Asia?

Muhammad Arshad Khan
Pakistan Institute of Development Economics, Pakistan

ABSTRACT

This chapter examines the hypotheses that trade liberalization and financial liberalization jointly enhances economic growth in the four South Asian countries including Bangladesh, India, Pakistan and Sri Lanka for the period 1970-2007 using bounds testing approach to cointegration. The results suggest that in the long-run except for Bangladesh, financial development plays no role in promoting economic growth in these countries. Furthermore, the results suggest that trade openness plays a significant role in promoting economic growth in Bangladesh and India, while exerts negative effect on Pakistan and no effect on Sri Lanka. The share of domestic investment influences real output significantly in Bangladesh, India and Pakistan. In the long- as well as short-run two-way causality between real output, trade openness, share of investment and inflation rate exists for the case of Bangladesh and India. For the case of India two-way causality between finance and growth exists in the short-run. For the case of Pakistan, there is an evidence of long-run causality between real output, finance, trade openness, share of investment and inflation rate. However, in the short-run, two-way causality between real output, trade openness and share of investment is existed and one-way causality between inflation rate, trade openness and share of investment is also observed. No evidence of short-run causality between finance and growth and vice versa for Pakistan has been seen. Finally, for Sri Lanka, an evidence of long-run causality between real output, finance, trade openness and investment share has been found. In the short-run one-way causality between finance-growth, trade-finance, trade-growth and trade-investment has been obtained. These mixed results suggest that the authorities may focuses more and more on the trade liberalization. In addition, there is a need to further deepen the banking and stock markets and provide investment friendly environment to enhance domestic investment which, in turn, promotes economic growth.

DOI: 10.4018/978-1-61520-709-1.ch008

INTRODUCTION

Economic growth is one of the major macroeconomic policy objectives of trade liberalization, financial development and information technology (Temple, 1999 and Santos-Paulino and Thirlwall, 2004). Economists are widely accepted the idea that financial repression and trade distortions impedes the process of economic development (Atje and Jovanovic, 1993; King and Levine, 1992, 1993, 1994; Levine and Renelt, 1992; Roubini and Sala-i-Martin, 1991 and Blackburn and Hung, 1998). Literature suggest that trade liberalization and financial development are predominant sources of comparative advantage and both liberalization policies reduces the inefficiencies in the production process and influences economic growth positively through a more efficient allocation of resources; greater competition; increase in the flow of knowledge and investment and foster capital accumulation and technical progress (Santos-Paulino and Thirlwall, 2004 and Hur *et al*., 2006). The rationale behind this argument is that countries with more open trade and financial policies may grow faster than those with restricted trade and financial policies.[1] The policymakers are now very much convinced that both liberalization policies are expected to exert positive impact on economic growth (Jin, 2000; Fry, 1995, 1997; Darrat, 1999; Levine, 1997, Mckinnon, 1973; Shaw, 1973; World Bank, 1987, 1989; Balassa, 1971, 1985; Bhagwati, 1978; Feder, 1983; Krueger, 1978 and Tyler, 1981).[2] The policymakers also realized that the object of building a powerful and prosperous nation could not be achieved with out the introduction of information technology (IT). Information and Communication Technology (ICT) offer a higher potential for making a positive contribution towards sustainable development by reducing the information and transportation costs, and facilitates cheap, equitable and resource-efficient access to information, accumulated knowledge and learning opportunities for all the citizens of a country.

A large body of literature considers various channels through which financial development, trade openness and information technology affect economic growth (Levine *et al*., 2000, Feldstein, 2003 and Frankel and Romer, 1999). Kletzer and Bardhan (1987) and Baldwin (1989) argue that countries with relatively well-developed financial system have comparative advantage in industries that relay more on external financial resources. Similarly, Beck (2003) and Svaleryd and Vlachos (2005) find the evidence that countries with a well-developed financial sector enjoys easier access to external finance than those without it, and tend to specialize in industries that are more dependent on external resources (Hur, *et al*., 2006). Rajan and Zingales (1998) argue that financial development serves as a source of comparative advantage and trade. This means that cheap access to external finance and financial development produces favorable impact on economic growth. Similarly, IT may affect economic activities through improving the quality of existing services, creating new services, raising labour productivity, increasing capital intensity, enhances economies of scale and creating new economic structure.

Over the past few decades researchers have shown that financial sector development plays a significant role in economic growth. In particular, they emphasizes the role of financial development in channeling savings to productive investment, improving corporate governance, reducing transaction and information costs, specialization and innovations and encouraging the adoption of new technology (Bencivenga and Smith, 1999; De Gregorio and Guidotti, 1995; Greenwood and Jovanovic, 1990 and Levine, 2004). Similarly, trade liberalization may helps to produce spillover effects over the rest of the economy through the efficiency, innovations, imitations and promotes overall economic development (Dodaro, 1993 and Deme, 2002).

A wide range of additional growth-inducing benefits have been attributed to trade including capacity utilization, enlarging market size,