

## IMPACT OF TRADE OPENNESS ON ECONOMIC GROWTH OF PAKISTAN

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*ABSTRACT*-The objective of this research paper is to analyze the impact of trade openness on economic growth of Pakistan. For this purpose, we collected data from different sources for the period of 1990-2017. Our dependent variable was GDP growth rate while independent variable included Foreign direct investment, Inflation rate, Real effective exchange rate, Trade openness and service sector. ADF test was used to check stationarity while ARDL and ECM models were used to determine long run and short-run relationship between variables. We have found that trade openness and services sector have positive relationship with GDP while inflation rate and FDI have negative relationship with GDP growth rate. Thus, Government should promote trade openness and services sector in order to earn foreign exchange by exporting more goods and services.

**Key Words:** GDP, FDI, TOP, Services sectors, Inflation rate.

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## **1.INTRODUCTION:**

### **1.1. Background of study:**

Pakistan opted different policies in different periods. In (1950 to 1960) Pakistan introduced export bonus scheme which raised level of the manufacturing of goods. In 1970's three policies were introduced to remove anti-export biasness. These policies were ending of export bonus scheme, devaluation of currency and license for entry in market. In 1980s Pakistan decreased tariff in order to stop smuggling of goods. In 1990s Government of Pakistan Introduced tariff reforms program". In 2000s focus was given on cultural exchange programs.

Some economist focus on service sector while other prefer on manufacturing sector. Some of them given importance to skilled labor while other emphasized on removal of tariff from Exports and imports. The data released by Economic survey of Pakistan show that Pakistan has been is taking interest in import more than export Pakistan has recently increased import of machinery 14.9%, Metal group 20.3, Chemical 11% and food group 18.5%. According to Trade policy of 2018, Pakistan balance of trade was US\$ 6-billion. Economists correlate many variables to find out relationship between trade and economic Growth. Shahbaz (2008) stated that said that we should follow the trade-led- growth or growth-led-trade. (Felix, 2004) has said that services have positive impact on economic growth. He said that investment has also had positive impact on services and GDP. He urged to eliminate trade barriers and reduce tariff to improve economic growth. For trade openness all tariff quotas should be eliminated. Trade openness can affect economic growth in three ways: increasing capital mobility, factor price equalization, transfer of knowledge & technology.

### **1.2 Main Research Problem:**

The main research problem of this research study is to analyze the “impact of trade openness on Economic growth of Pakistan”

### **1.3. Objective of the study:**

The objectives of the study are stated as under:-

- To study the causes of low exports and high imports of Pakistan.
- To examine the impact of fluctuation in exchange rate on imports and imports of Pakistan
- To analyze the impact of trade openness on economic growth of Pakistan
- To assess the impact of globalization on Pakistan’s economy.

### **1.4 Scope of the study:**

The study helps to understand effectiveness of trade openness on economic growth of Pakistan. We have discussed all trade theories and analyzed trade situation in Pakistan. The results of this study will definitely be helpful for policy makers, academicians and new researchers in framing policies which enhance Pakistan’s trade and conduct further research on different aspects of trade which has not included into this study.

## **2.LITERATURE REVIEW:**

Different economists described in different ways the effect of trade openness on Economic growth. The International trade and its link with economic growth is still have some doubts.

Romer and Locus (1988), discovered an “Endogenous growth theory” through dynamic gain.They suggested that due to trade liberalization we can make progress in innovations, technology, production and resources allocations. Batiz (1995) examined the “Economic integration and endogenous

growth” and suggested that there was a link between knowledge and trade. He argued that international trade could enhance transfer of knowledge and technology and reduce unemployment. Lopez (1994) examined “The environment as a factor of production: The effects of economic growth and trade liberalization” and suggested that trade liberalization can improve economic growth if country will adopt new technology for improving exports.

Miller and Mukti (2000) analyzed “The effects of openness, Trade Orientation, and human

capital on total factor of productivity” and concluded that Human capital and trade openness have positive impact on productivity. Konan and Masks (2006) analyzed “Quantifying the impact of services liberalization in a developing country” and concluded that liberalization in services is better and cheaper than goods trade. Service trade was significant and had important role in human welfare. Karras (2003) examined “Trade Openness and Economic growth: Can we estimate the precise effect?” He used two panel data set first is from 1951 to 1998 and second is from 1960 to 1970. He used explanatory variables population, government and export plus imports. He used simple Ordinary Least Square regression model and other for finding growth rate and relations between other variables. He suggested to promote International trade and for this purpose government should introduce pro-trade policy framework.

Eschenbach et al., (2004) examined results of “Services policy reform and economic growth in transition economies” by using time series data of countries from 1994 to 2004. He applied simple OLS model for finding results of poorest countries. He suggests that improving investment for improving the growth. He concluded that there is no any multiplier for finding ~~imports~~ in service reforms and trade openness.

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Awan (2014 ) and (2015) argued that promotion of services sector will reduce environmental pollution and by exporting services will cause high level of income for countries like Pakistan. He emphasized that more attention should be paid on skill development and training of labour force so that it can play an effective role in economic development.

Intisar et al., (2020) worked on, “Impact of Trade Openness and Human Capital on Economic Growth: A Comparative Investigation of Asian Countries”. They used data of 19 Asian countries from 1987-2017.

They concluded that trade openness and human capital have a significant and positive relationship while labor force had a negative effect on economic growth in Southern Asian countries while and in the case of Western Asia, the impact was positive. Foreign direct investment (FDI) had a negative and significant impact on GDP per capita (GDPPC) in Western Asia while it was positive and significant impact in Southern Asia. Total population (TPOP) has anegative impact on GDPPC in both regions. Furthermore, human capital had a positive and significant impact on trade openness in both zones. Meanwhile, labor force participation (LFP) had a positive and significant impact on trade openness in Southern Asia and a negative effect in the Western Asia. Trade openness and economic growth had bidirectional causality in Western Asia and unidirectional causality in Southern Asia. It also showed that human capital and economic growth ha unidirectional causality in both regions.

### **3. THEORITICAL FRAMEWORK:**

#### **3.1: Classical theory:**

This theory was developed by Adam Smith in 1776. Ricardo and Heckscher Ohlin also developed model in which they described that resources

and technology used in production are exogenous. Free trade can increase return to scale by proper division of labor and allocation of resources in different sectors. So, productivity and income can increase in a country. By change in technology we can promote country to the next level. Progress in technology and production can move us to long-run growth in country. However, it also depends on the capital distribution of the country. They concluded that by increase labor, capital and free trade can improve economic growth and advancement in technology can move it to the next level

### **3:1.1. Neo classical (Exogenous model):**

Solow and Swan stated that if we want to increase in economic growth we have to, increase in proportion of GDP, as increase return to diminish the scale and economy convergent to steady-state. As improvement in technology can cause increase productivity of labor, especially, the under developed countries should compare with other developed countries. This theory mostly focusses on capital stock and emphasizes that no country can make progress without having sufficient quantity of capital stock vis-à-vis labour force.

### **3.1.2 Harrods Dommer Model:**

It is also called saving and investment model. It is a type of Neo-classical model. It states that saving is must for investment because no country could make investment if it does not have sufficient amount of savings. But when a country more focus on saving by curbing consumption it could not make investment.

### **3.1.3 New Economic Growth theory (Endogenous Theory):**

It was presented by Paul Romer and Locus Robert and it emphasized on human capital. They suggest with training, education and knowledge of worker can help in technological progress. This theory focuses on human

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capital and said that this an important factor for economic growth.

### **3.2 Theories on Trade Openness:**

#### **3.2.1: Theory of Mercantilist:**

Mercantilism was a common practice before industrialization and most of nations generate income through trade of goods which was bought from abundant areas and sold to scarcity areas. Mercantilism was the profession of Arabs who travelled in different parts of the world for selling and purchasing mercantile goods.

#### **3.2.2 Theory of competitive advantage:**

Adam Smith presented this theory in his book “Wealth of Nations” in 1776. According to Smith, a country or nation should produce those goods in which it is more efficient and should export those goods while other nation should produce and export those goods in which their country is more efficient. Adam Smith named his theory as absolute advantage theory (Schumacher, 2012).

#### **3.2.3 Theory of absolute advantage:**

Another theory of trade was presented by the David Ricardo after the thirteen year of Wealth of Nations. The theory of David Ricardo was extremely modified and named as Comparative advantage theory. The synthesis of comparative advantage was if a nation can produce all goods with its own cheaper resources than any other nation, trade still could be beneficial for both nations. The idea behind this theory was more efficient and less efficient a country with efficient resource will produce that good and other country will produce that goods in which its cost of production would lower. David Ricardo presented the idea of specialization of the countries. Country should specialize in the production of those goods in which it is comparatively

more efficient and other country will produce those goods in which it has less loss comparatively with other countries (Ruffin, 2002).

#### **4. RESEARCH METHODOLOGY:**

##### **4.1 Nature of Research:**

Our research is quantitative in nature so we have used quantitative data and quantitative methods in this study.

##### **4.2 Types of Data and sources:**

We have use secondary data for our research study. The data was taken from WorldDevelopment Indicator, State bank of Pakistan and Pakistan's economic survey.

##### **4.3 Selected Variables:**

###### **4.3.1 Independent Variables:**

Our independent variables are the following: -

1. Trade openness
2. Foreign Direct investment
3. Services
4. Inflation
5. Real Effective Exchange Rate

###### **4.3.2 Dependent variable:**

Our dependent variable is GDP (Gross Domestic Product).

###### **4.3.3. Sample of study:**

The sampling period of our study is from 1990-2017.

###### **4.3.4 Econometric Model:**

The model of our study is shown in the following equation.

Where:

$$\text{GDP} = f(\text{Top} + \text{INF} + \text{REER} + \text{FDI} + \text{SER})$$

GDP= Gross Domestic Product

TOP= Trade Openness

REER= Real exchange rate

SER = services

INF= inflation

The econometric model of this study is given below:-

$$Y_t = \beta_0 + \beta_1 X_{1t} + \beta_2 X_{2t} + \beta_3 X_{3t} + \beta_4 X_{4t} + \beta_5 X_{5t} + \epsilon$$

Y=GDP

X<sub>1</sub>= Trade openness

X<sub>2</sub>= Inflation

X<sub>3</sub>= Real exchange Rate

X<sub>4</sub>= foreign direct investment

X<sub>5</sub> = services.

€= Error term.

#### 4.3.5 Hypothesis of the study:

The hypothesis of this study are stated as under: -

H<sub>0</sub>: There is no relationship between GDP and total openness in Pakistan.

H<sub>1</sub>: There is relationship between GDP and total openness in Pakistan.

H<sub>0</sub>: There is no link between services and total openness in Pakistan.

H<sub>1</sub>: There is a significant link between services and total openness in Pakistan.

H<sub>0</sub>: There is no relation between total openness and inflation rate

H<sub>1</sub>: There is relation between total openness and inflation rate

H<sub>0</sub>: there is no significant relationship between total openness and FDI.

H<sub>1</sub>: There is significant relation between total openness and FDI.

H<sub>0</sub>: There is no relationship between real exchange rate and total openness in Pakistan.

H<sub>1</sub>: There is significant relationship between real exchange rate and total openness in Pakistan.

#### 4.3.6 Analytical Techniques:

Analytical techniques used in this study are

- 1: descriptive statistics
- 2: correlation analysis
- 3: Augmented Dickey Fuller (ADF) Test
- 4: Auto Regressive Distributed Lag (ARDL) model
- 5: Error Correction Model (ECM).
- 6: ARCH test of Heteroskedasticity
- 7: Diagnostic Test.
- 8: checking Stability

### 5. DATA ANALYSIS:

We draw the results through E-views 9 software which are given below in the tables.

#### 5.1 DESCRIPTIVE STATISTICS (Annual data as %):

The results of descriptive statistics are shown in Table 1.

Table 1: Descriptive statistics

	GDP	FDI	INF	REER	SER	TOP
Mean	4.76	0.77	8.90	138.36	45.72	25.63
Median	4.83	0.58	7.76	117.68	44.90	25.75
Maximum	10.21	3.66	26.66	231.41	53.17	32.98
Minimum	0.46	-0.06	2.52	95.26	37.08	17.01
Std. Dev.	2.15	0.79	5.25	42.30	4.78	4.08
Skewness	0.07	2.14	1.51	0.68	0.13	-0.19
Kurtosis	2.68	7.65	5.36	1.88	1.95	2.50
Jarque-Bera	0.23	80.22	29.52	6.26	2.33	0.79
Probability	0.88	0.45	0.51	0.05	0.31	0.67

Descriptive statistic is basically used for checking average and standard deviation of the variables. It tell us average value of variables with different time periods and how much they deviate from average value. Stander deviation with minimum value shows stability of variables. The results in table 2 shows that Null hypothesis is accepted because the residuals are normal.

The average of the gross domestic product is 4.76 with a standard deviation of 2.15. The average of FDI is 0.77 with a standard deviation of 0.79 while average of INF is 8.90 with the standard aviation of 5.25. Whereas the average of the REER is 1.38 with the standard deviation of 42.30 The average of SER is 45.72 with a standard deviation of 4.78. The average value of TOP is 25.63 with the standard deviation of 4.08.

## 5.2 Correlation Matrix:

The results of correlation analysis are shown in table 2:

Table 2: Results of Correlation Matrix

Variables	GDP	FDI	INF	REER	SER	TOP
GDP	1	0.09	0.06	0.29	0.12	0.14
FDI	0.09	1	0.06	0.58	0.57	0.32
INF	0.06	0.06	1	0.15	0.21	0.39
REER	0.29	0.58	0.15	1	0.78	0.59
SER	0.12	0.57	0.21	0.78	1	0.76
TOP	0.14	0.32	0.39	0.59	0.76	1

Correlation analysis indicates the strength of association between two or more variables. Table 2 shows values of correlation among variables. There should not be correlation greater than 80% as it will make results doubtful.

Below 80% association is normal. Foreign Direct Investment has 9.1%, Inflation has 6.9%, Real Exchange Rate has 29%, Services has 12% and Trade openness has 14.1% association with GDP. All the variables are positively correlated with one another as we can see in the above table.

### 5.3 Unit Root Test:

The results of ADF test are shown in Table 3:

Table 3: ADF Results

Variables	LEVEL		1 <sup>st</sup> /difference		2nd Difference		Results
	Trend	Intercept	Trend	Intercept	Trend	Intercept	
GDP	0.008	0.002	0.008	0.002	0.00	0.00	I (0)
FDI	0.08	0.06	0.002	0.004	0.00	0.00	I (1)
INF	0.04	0.02	0.00	0.00	0.00	0.00	I (0)
REER	0.37	0.54	0.11	0.006	0.00	0.00	I (1)
SER	0.19	0.74	0.00	0.00	0.00	0.00	I (1)
TOP	0.19	0.92	0.00	0.00	0.00	0.00	I (1)

Table 3 shows the results of Unit root test. Augment Dickey Fuller test is used for checking the stationary of variables. Stationary means the mean of variable is zero and standard deviation is constant. According to result we can estimate that Gross Domestic Product (GDP) is stationary at ~~level~~ which includes trend, because probability value of ADF test is less than the level of significance. Thus, the variable Foreign Direct Investment (FDI) is stationary at first difference including trend, because ADF prob. Value is 0.00. Similarly, Inflation (INF) is stationary at level with including intercept as we can see the p-value is 0.02,

which is less than level of significance 5%. Prob. Value of Real Effective Exchange Rate (REER) is stationary at first difference including intercept which is 0.00, thus this variable is integrated at first difference. Services (SER) is integrated at first difference with trend as it has prob. value 0.00 which is also less than level of significance 0.05 or 5%. Trade openness (TOP) is integrated at first difference with prob.

#### 5.4 ARDL Bound Test

ARDL bound test estimate the impact of explanatory variables on dependent variable in the long run. ARDL bound test is applied to determine long run relationship between variables. The results are shown in Table 4: -

Table 4 Long-run results of Bound Test

Test Statistic	Value	Signif.	I(0)	I(1)
F-StatisticK	6.655	10%	2.6	3.35
		5%	2.62	3.79
		2.5%	2.69	4.18
		1%	3.41	4.68

Table 4 show the result of Autoregressive distributive lag (ARDL) bound test. Criteria for presence of long-term association among the variable depends on critical values. In table 4 there are four significance value 10%, 5%, 2.5% and 1%. And if the calculated value of F-test is bigger than the value of I (1) bound at specific significance level then we can discard null hypothesis and concludes that the presence of long-term association. F-Bounds test shows the calculated F test value is 6.650816 that is bigger than the value of I (1) bound at 5% level of significance. So, we can reject the null hypothesis and conclude that there is long run relationship between

dependent and independent variables. So, we can apply auto regressive distributive lag (ARDL) model for short run and long run results.

### 5.5 ARDL Model: Long-run relationship between variables:

The results of ARDL model are shown in Table 5:-

Table 5 Long-run relationship between variables

Variables	Coefficients	Standard Error	T-statistics	Probability
FDI	-0.26	0.38	-0.69	0.49
INF	-0.15	0.05	-2.91	0.00
SER	0.15	0.07	1.98	0.05
TOP	0.15	0.06	3.91	0.04
REER	0.03	0.00	6.31	0.00
C	-6.32	4.80	-1.31	0.19

Table 5 shows the results of long-run relationship between dependent and explanatory variables. Coefficient of Foreign Direct Investment is -0.26 which implies that one unit increases in FDI will causes 26. decrease in Economic Growth (GDP). The sign of coefficient of FDI is negative which shows decrease in domestic growth. Coefficient of Inflation (INF) is -0.15 which means one unit increases in inflation rate will likely to cause 15% decrease in economic growth (GDP) annually in long-run. If inflation increase the value of currency will decrease which causes reduction in economic growth that's why inflation has negative impact on economic growth. Services (SER)has coefficient 0.15 which shows by 15% increase in economic Growth by one unit increases in services. Coefficient of Trade Openness (TOP) is 0.05 which implies one unit increases in TOP it will increase GDP by 5%.

Real Effective Exchange Rate has coefficient 0.03 which means by one unit increase in REER will likely to cause 3% increase in Economic Growth. Sign of REER is positive, showing significant relationship between economic growth and REER. Intercept term shows that if all the explanatory values are assumed to be constant then negative impact will be on economic growth. Negative sign shows that economic growth will be decline by 6.23%.

**5.6 Co-integration and Short-Run Results:**

The short run relationship between variables are shown in Table 6:

Table 6: short-run relationship between variables

Variable	Coefficient	S.E	T-Statistic	P-Value
D(GDP)	0.24	0.16	1.50	0.14
D(FDI)	2.09	0.65	3.19	0.00
D(INF)	0.26	0.08	3.22	0.00
D(REER)	0.05	0.01	4.49	0.00
D (GDP-1)	-0.59	0.28	-2.08	0.04
D(TR)	0.08	0.09	0.91	0.36
ECM	-1.56	0.26	-5.98	0.00
R- Square	0.661994	Mean dependent var		4.947802
Adj. R-Square	0.509346	S.D. Dependent Var		2.014980
S.E. of regression	1.411427	F-statistic		4.336733
Sum squared Resid	61.75593	Prob(F-statistic)		0.000326
DW-Stat	1.981990			

Table 6 shows the short run results and co-integrating between dependent and independent variables. While applying ARDL model if we use non stationary data then results of regression model will be spurious. Regression equation does not provide any information about long run relationship between variables; it's just providing information about short run results. To avoid that problem, we just interested in long run relationships between variables. In order to resolve this issue, the concept of ECM and co-integration becomes imperative. The value of  $R^2$  in our model is 0.661994; it means that 66.2% variations in dependent variable is due to independent variables. Or we can say that dependent variable 66.2% explained by independent variables. Probability value of F-statistics is 0.000326 that is less than the level of significance; it means that overall model is goodness of fit. Finally, Durbin-Watson statistics is 1.981990, which implies that there is no auto correlation in the variables.

### 5.7 Diagnostic Test:

The results of diagnostic test are shown in table 7:-

Table 7 Breusch-Godfrey Serial Correlation LM Test

F-statistics	1.3248	Prob. F (4,23)	0.2906
Obs*R-squared	9.2393	Prob. Chi-Square (4)	0.0832

Table 7 shows the results of serial correlation LM test. Breusch-Godfrey technique was used to check the issue of serial correlation in this model. Null hypothesis of serial correlation test states that there is no autocorrelation exists in error terms of this model. And alternative hypothesis of this test states that autocorrelation exists. P-value of F-statistics is 0.2906 which is greater than the level of significance (5%), this means that we cannot

reject  $H_0$  and conclude that there is no serial correlation exists in our model.

### 5.8 Heteroscedasticity Test:

Table 8 Heteroscedasticity ARCH Test

F-statistic	0.3376	Prob. F (16,27)	0.9867
Obs*R-squared	7.3359	Prob. Chi-Square (16)	0.9662

Table 9 shows the results of heteroscedasticity test. ARCH technique was used to check the problem of heteroscedasticity in this model. Null hypothesis of this test states that there is homoscedasticity in the error terms of this model. And alternative hypothesis of this test states that heteroscedasticity exists in the disturbances. P-value of F-statistics is 0.9867 which is greater than the level of significance (5%), this means that we cannot reject  $H_0$  and accept  $H_1$ .

### 6. Findings of study:

Foreign Direct Investment is an important indicator for Economic growth. It is a type of investment which is done by any individual or business in any other country. It helps to improve economic growth in any country. In this study the co-efficient of variable is -0.268321, which means by if one unit increases in FDI it will likely to cause 26.83% decrease in GDP in the long run. Calculated value of t-statistic is 0.6997 and p-value is greater than value of significance. That's why FDI is insignificant for GDP in Pakistan's case. Inflation means increase in the price level of goods and services. It affects negatively to GDP. In our findings, coefficient of Inflation is -1.52297, which means if on- unit increases in inflation rate it will likely to cause decrease in

GDP by 15.22%. The value of t-stat is 2.9112 and p-value is 0.007 which shows this variable significantly affect GDP in the long-run.

Services are not physical goods which can be touched or seen, these are paid services like telecommunication services for trade in our study. Services sector has positive effect on Economic Growth. In our results, coefficient value of services is 0.1505 which means one unit increases in services sector will likely to cause increase in GDP by 15.05%. Value of t-stat is 1.9817 and p-value is 0.05, which is less than value of significance. It means improvement in Services Sector causes increase in GDP.

According to ARDL results of our study, the coefficient value of TOP is 0.0564 which means 5.65% will increase in GDP if one unit increases in Trade Openness. t-stat has value of 6.8046 and prob. Value is 0.00, which indicates that trade openness has positive effect on Economic Growth of Pakistan. Real Effective Exchange rate has positive relationship with economic growth. Increase in exchange rate causes revalue the currency of any country so growth will be increased with improvement in currency value. In our study, the coefficient value of REER in long-run is 0.0352, which indicates if one unit increases in REER it will likely to increase in GDP by 3.52%. T-statistics has value 6.8046 which is greater than 2 and p-value is 0.00 that shows significant relationship between Real Effective Exchange rate and Economic Growth in Pakistan in long-run.

## **7. CONCLUSIONS:**

Trade openness play a vital role in the economic growth of a country. Service sector is a major determinant of economic growth and the importance of service sector is more in the case of developing nations like Pakistan. For developing countries, the fluctuations in REER destabilizes the economy. The impact of real exchange rate may be negative or positive. It be determined by

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the situation of the economy. So Pakistan should control fluctuations in exchange rate as it affects prices of goods and services inside and outside the country. Similarly, international trade plays a significant role in economic growth. In our study the results highlight the positive effect of trade openness on Pakistan's economy. So the Government of Pakistan should take measures to open the economy and to make its industry and business competitive. Inflation is dangerous for the economy because it raises price level and affects the local customers as well as foreign buyers of our goods. It must be kept under control. Services is positively related to GDP. In developing countries, the share of services sector is high but it is low in Pakistan. Mostly people are engaged in services sector. Pakistan should expand its service sector because it does not produce pollution and spoil the environment. Although Pakistan like other countries invites foreign direct investment but it has negative effect on the economy and enhances debt burden. Mostly foreign direct investment is made in speculative activities or in high return sector just like IPPS where Pakistan's liabilities have increased to \$14 billion and Pakistan is paying huge amount to independent power producers every year as capacity payments. It proves that FDI has no positive effect for the countries like Pakistan.

## **8. POLICY RECOMMENDATIONS:**

The policy recommendations of this study are given as under: -

- ▶ Trade openness should be taken as a core policy by the Government.
- ▶ Foreign direct investment (FDI) should be discouraged as it has no positive effect on Pakistan's economy.
- ▶ Government should promote substitute industry to save foreign exchange and promote local industry.

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### CONTRIBUTION OF AUTHORS AND CONFLICT OF INTEREST

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This research work was carried out in collaboration between two authors.

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Both authors read the manuscript carefully and declared no conflict of interest with any person or institution.

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