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Impact of Trade Liberalization on Employment: Review of SAARC Countries

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Abstract

Globalization has become the buzzword for many economies today that fails them to think in isolation for their own good. Today, developing economies race to exploit maximum growth opportunities without ever considering social costs associated. One such cost can be seen on the level of Employment (Domestic Labour Demand). The objective of this study is to observe the effect of FTA on employment levels in the context of SAARC Countries including Pakistan, India, Bangladesh and Sri Lanka. Traditionally, positive impact has been observed of Free Trade on the level of employment in developed countries; whereas empirical evidences have suggested negative relationship in case of developing countries.

Key Words: Economic Globalization, Multilateral Trade, Labour Demand, SAARC Economies

1. Introduction

The history of international trade has been long and vivacious one, interspersed by wars, conflicts and dramatic changes in philosophies and principals about international trade. Since trade has its positive impacts on economic growth of the economy so the focus of governments always has been to boost exports and explore markets for the locally produced goods to obtain higher levels of growth of the economy. International trade, over the years, has become more liberalized. More liberalized international trade calls for abolishing or lessening of enticements provided by the governments. Moreover, it also demands amputation of barriers to free trade among nations.

There is a substantial theoretical and empirical economic literature on impact of liberalized trade on macroeconomic conditions of the economy. Adam Smith and David Recardo, the Classical economists, strongly favoured free trade amongst the economies. These classical economists were of the opinion that free and liberalized trade could lead to economic prosperity. most of the recent empirical studies such as Rodriguez & Rodrick (1981), Edwards (1993), Krueger (1997), McCulloch et al. (2001), Greenaway et al. (2002), Berg & Krueger (2003), Baldwin (2004), Santos-Paulino & Thirlwall (2004), Johnson (2013) favored trade liberalization for the growth and development of the economies. On the contrary, some of the economists argue that liberalized trade can be harmful for the natural balance of the market place and it may have its adverse impacts on developing economies.

The expansion of regional economic integration of Europe and North American economies worked as driving force in the process of trade liberalization. Moreover, the adaptation of much outward-oriented trade policies by emerging economies of the world such as China, India and Mexico coupled with unilateral trade liberalization measures by developing economies ignited the process of trade liberalization. Furthermore, the introduction of information technology, developments in the telecommunication and increased flows of foreign direct investment, especially during the last two decades, extended the unprecedented avenues for expanded trade growth. The present study is an attempt to observe the impact of trade liberalization on employment in the context of SAARC Countries and examine the past research papers as how their study has concluded in this regard. With this thought, what could be the policy implications in view of the relationship revealed?

2. Literature Review

There are many empirical studies that focussed on the analysis of impact of trade liberalization on employment in the economies. Baldwin (2006) analysed the effect of trade liberalization on employment in OECD (Organization for Economic Cooperation and Development) countries. The study concluded that trade liberalization shows insignificant impact in these economies. Moreover, the study revealed that increase in imports has negative effect the employment in the low-technology sectors such as textiles, apparels, food, furniture, etc. The study also suggested it difficult, for the policy makers, to predict direction and nature of changes in employment as a result of trade and off-shoring.

In another important study, Hoekman & Winters (2005) concluded that, in recent times, trade has played a greater role in defining labour outcomes than what was in the 1990s. The liberalized trade plays its role not only through intermediaries and services but also through transfer of technological innovation and modern techniques. Another key finding of this study was that, wage responses to trade are greater than employment impacts in developing countries especially in those sectors of manufacturing that experienced largest tariff reductions. Methodologies used by past researchers to observe the trends of trade and impact on employment can be grouped in four approaches: factor-content approach, competitiveness approach, growth accounting/productivity approach and econometric approach. The result of analysis may vary, considerably, with the methodology and data set used for the analysis. Different models suggest that relative changes in labour demand due to trade my lead to unemployment in some economies whereas in certain economies it may lead to a decline in unemployment levels.

Postulates of factor content approach argue that demand for unskilled labour decreases with the increase in exports in the economy with high ratio of skilled to unskilled labour. Since benefits or gains from trade are biased towards the most productive (but capital-intensive and/or skill-labour intensive) firms so less productive or small but labour-intensive firms are crowded out (Janiak, 2006). In this process, job losses due to exit of small firms outweighs the job creation by expansion of large firms and results in an increase in unemployment in the economy. This mechanism is similar to the "*barriers to entry*" in goods market which may cause a rise in equilibrium unemployment. In another study, Wood (1994) has suggested that import competition from unskilled-labour abundant economy may negatively affect low-skilled labour in industrialized economies.

So these studies suggest that trade liberalization impacts also depends on the structure of other macroeconomic factors such as labour market, gender, education, product market etc. Yet another study has proposed that unemployment is a majorly caused by the trade policies under different business cycles situations. Since distinction in employment conditions between effects of trade and general recessions cannot be made that is why most of the protagonists of liberalized trade tend to make these theories. As a researcher (Rama, 2003) has suggested that it is only a fraction of labour which is out of job due to liberalization. Moreover, he found that, in more open economies, unemployment rates were not systematically higher.

The second approach, considers competitiveness and degree of openness to assess the effect of liberalized trade on employment. Some of the empirical researchers use exports plus imports as ratio or percentage of GDP as a measure of degree of openness of the economy. But growth in exports and imports of the economy also depend on rate of growth of the economy. In this volume of trade to GDP ratio both numerator and denominator are related to GDP growth of the economy. In this situation, the removal of trade barriers, merely, would not guarantee increase in trade (Lee, Ricci, & Rigobon, 2004). The comparative advantage theory of David Ricardo being the foundation of Heckscher-Ohlin Model has been used in many researches. This model, essentially, suggests that countries would export products that utilize their abundant and cheap factor of production and import products whose production requires economy's scarce factors. According to H.O. Model, not only the relative commodity prices but also the relative factor prices are equalized with the free trade. But this has found least agreement with the evidence; since factors, firms and labour are heterogeneous (Melitz, 2003).

The growth accounting approach suggests that the variations in employment associated to economic growth can be broken down into four components such as domestic demand, exports, imports and productivity. Researchers have empirically concluded that international trade played modes role in changes in employment in short run. But the productivity is considered to be an important element for employment of labour. For example, the studies such as Gaston & Trefler (1997) and Trefler (2001) analysed the employment effects of Free Trade Agreement between Canada and United States in Canadian manufacturing. The results of empirical analysis revealed that tariff cuts, following the FTA, contributed to reduction in employment levels. Moreover, these cuts showed remarkable contribution in productivity. This increased productivity lead to competence in the international market. Whereas another study on Japanese Car Industry, (Beason & Weinstein, 1996) suggests that industries protected by industrial policies had decreasing returns to scale and did not experience productivity gains. However, this approach is based on the assumption that components of employment are independent. This is rarely true in the real world because evidence find that Labour productivity and trade growth are correlated (Bernard & Jensen, 1999).

The fourth approach, generally, uses econometric regression models to measure the impact trade on employment level in the context of static (closed) or dynamic (open) framework. Many researchers have used Labour demand elasticity, Import elasticity, Armington Elasticity, Generalized Method of Moment estimation, Computable General Equilibrium structure, and Import penetration, etc. to measure the magnitude of impact that trade has on employment. Several disaggregated studies conducted by ILO and WTO have concluded varying results using CGE model. Some of the empirical studies predict that agricultural liberalization in context of Doha Round will lead to employment losses in sub-Saharan Africa, while others predict gain for the region[1].

3. Trade Liberalization and Its Impact On Employment In SAARC

Globalization and more specifically trade liberalization presents new possibilities for eliminating global poverty, directly or indirectly through social, cultural, scientific and technological exchanges along with trade and finance. Some important low-income countries like China and India have used globalization to their advantage and thus have been able to achieve a precedent growth rate, reducing some international inequalities. Following are the literature analysis of individual major countries of South Asian Association for Regional Cooperation (SAARC) namely Bangladesh, India, Pakistan and Sri Lanka.

3.1. Bangladesh

Bangladesh economy, after independence in 1971, followed a highly restricted trade strategy of high tariffs and non-tariff barriers to trade. Moreover, the economy adopted more overvalued exchange rate system or more comprehensive termed as Import Substitution. The trade regime was shifted in the mid-1980s and the fastest pace of liberalization took place in the period of 1991-95. Raihan (2008) conducted a numerical study to observe the relationship in context of manufacturing industries. He concluded that, in general, trade liberalization, in Bangladesh, has generated employment in the major export-oriented industries where as labour suffered in major import-substituting industries such as textiles and paper products.

Another study (Rahman, Shadat, & Raihan, 2007) concluded that sectoral and overall employment has experienced negative growth particularly in agriculture and industrial sector in the periods of 1991-95. Although employment in the manufacturing did increase in the third phase of liberalization (after 2000) but the sector failed to absorb the increasing labour force as pointed out in low share of total employment. Another key finding of this study depends on the wage and price stickiness. It proposed that stickiness of wages during periods of rising productivity in manufacturing sector would imply that workers were not getting a share which might have led to a fall in competitiveness as a trade-off with the real wage determination. Thus, generally, trade liberalization has negatively impacted the employment structure of Bangladesh.

An alternative study (Williamson, 1999) proposed that while trade liberalized reforms have negatively impacted employment but it has potential to become positive. So it has suggested formulation of trade reforms in those sectors where Bangladesh has lagged such as financial sector, infrastructure and privatization.

3.2. India

One of the populous countries and among largest economies of the world, India has vast natural resource and also has one of the widest income inequalities in the world. India had been in favour of inward-oriented growth for a long period; however its trade began to be liberalized in the late 1970s. India is among the founding countries of GATT and WTO. It had one of the most restrictive import-tariff structures among developing countries, which led to inefficient resource allocation. Under the Trade Related Investment Measures and Information Technology Agreement, the tariffs were considerably brought down. A study conducted in the earlier period of year 2000 (Chadha, Brown, Deardorff, & Stern, 2000), modelled a single set of static equilibrium conditions, whose result were only correct for relatively long time horizon like 2-3 years, to determine the impact WTO policies would have on Indian Manufacturing. They concluded that multilateral as well as unilateral liberalization enhances the economic welfare of major trading regions/industries such as Agriculture, Textile, Leather, Tobacco etc.

In an important study, Ramaswamy (2003), using disaggregated industry data, concluded a positive impact of liberalized trade on labour demand in the manufacturing sector of Indian economy. These impacts were not only higher for Indian states with more flexible labour regulations; but were also negatively impacted by the trade reforms. They concluded that after reforms, volatility in productivity and outputs would be transferred into a larger wage and employment volatility. A series of ILO multicounty case studies on China, Malaysia, India, Mexico and Brazil focused on manufacturing because it had spearheaded trade growth and strongly affected by trade expansion. The studies concluded that unskilled workers have benefited more than the skilled workers due to faster employment growth in export-oriented industries. But India did not get much benefit as Indian economy was unable to shift its export-base away from primary commodities. So, Indian economy could not exploit the growing demand for manufactured exports.

3.3. Pakistan

Pakistan is one of the founding members of GATT (General Agreement on Trade and Tariffs) and of the WTO. After its independence in 1947, like many developing countries at that time, Pakistan too adopted Import Substitution (IS) policies impressed by the miraculous western industrialization in 1950s and 60s. However in the 1970s with devaluation of Pakistani Rupee followed by ending of import licences, development became conversant with Export promotion strategy. Liberalization of Pakistan economy started, with the help of the World Bank and the IMF in 1982-83 to improve efficiency through further involvelment of private sector. Major reform in this regard was the de-linking of Pakistani Rupee from U.S. Dollar. The process of trade liberalization was implemented vigorously after 1988 with the formulation of some measures such as privatization, and opening up of capital markets to foreign investors. With the launch of more comprehensive Economic revival Programme (in 1999), which included reduction of direct state intervention in the economy and improvement in tax base, Pakistan moved towards more integrated economy in order to meet global challenges.

Pakistan has faced many losses and also gained benefits, from international events such as Oil price shocks, 9/11, and Korean War etc. Much research has been done to assess the impacts of trade liberalization on employment in Pakistan. A paper (Yasmin & Khan, 2005), has investigated how trade liberalization has effected employment and labour demnad elasticities in the manufacturing sector of Pakistan over time periods of 1970-71 to 1995-96. It concluded that trade liberalization is associated with relative increase in the price of the good that makes intensive use of relatively abundant labour factor, which is further translated into higher demand for labour, thereby generating employment opportunities in the economy. This suggests that free trade has motivated Pakistan to produce labour-intensive goods in the long run and make use of its comparative advantage in the textile sector.

Another study (Chishti & Malik, 2001) concluded in the same manner that trade liberalization moves would help minimize the control of individuals on trade, leaving less room for exploitations and use of discretionary powers for private gains and in this manner it would lead the economy to be run in accordance with forces of demand and supply. Again this would be only possible, when Pakistan take advantage of its comparative edge in textile, leather and agricultural products over others. A more comprehensive study (Siddiqui, 2007) made use of dynamic CGE framework empirically concluded that despite the growth enhancing impact of global liberalization on agricultural trade, it has resulted in reduction in the agriculture trade, causing employment to decline in this sector.

The importance of informal sector has gained momentum in the developing countries since it accounts for most of the employment. In some countries trade reform reduces unemployment, and raises the informal wage, while others experience the opposite. A research study, (Bandopadhyay, 2007), have used Harris-Todaro framework to determine the social impacts of trade policies in pakistan, with respect to degree of capital mobility and effeciency wage. According to this study, tarriff reduction raises the problem of urban unemployment and produces ambiguous effects on social welfare in case of perfect capital mobility. However, such reformatory practice lowers the urban unemployment and raises social welfare when capital is mobile only between the rural and urban formal sector.

3.4. Sri Lanka

Sri Lanka is also one of the founding members of WTO. It started to adopt trade liberalization policies, well before the rest of the South Asia in the late 1970s. Since then it has operated a unified exchange rate under managed float system which became fully floated in 2001. Most of the quantitative restrictions were removed in 1980s, by WTO, and the remaining were eventually removed in 1998. A study was carried out that believe that a country need not necessarily follow stringent single policy towards liberalization in a globalized economy. A positive and statistically significant correlation between exports and employment is found. While opposite is true for import. And so trade liberalization is likely to create jobs and increase relative wages over time.

Another finding (Wilson, 2002) suggests that higher divergence of shares of agricultural labour and rural population in Sri Lanka, that is high value of agricultural exports per agricultural labour. The country is significantly export-oriented giving clear competitive advantage in agricultural exports and relatively skilled labour force deployed in agriculture.

4. Concluding Remarks

More liberalized international trade is considered to be an important driving force for the stimulation of growth and generation of employment opportunities in the economy. Increase in share of manufactured products in exports leads to higher growth levels of the economy. Moreover, more liberalized trade has its impacts on job creation and poverty alleviation process. The present analysis is aimed at to assess the varying impacts of trade liberalization on employment. Moreover, it also takes into account how this impact varies with the changes in trade structure, labour market, product market and other macroeconomic variables in the economy. Developing economies of SAARC, with the exception of India to some extent, have not been able to take advantage of liberalized trade through specialization. From the theoretical and literature analysis it has been established that, trade liberalization may have positive impacts in some countries, but it is not the sufficient condition and does not imply that trade liberalization per se is good. Following may be the policy implications that can be concluded in view of the literature reviews of past studies.

In Pakistan, India, and Bangladesh, increased trade liberalization has reduced the employment in manufacturing side leaving most of the workers underemployed and at lower wages in other informal sectors and agriculture sector; thereby leading to lower share of manufactured output in the total exports. So more liberalized trade would badly hurt this sector. Sri Lanka on the other hand has successfully come on path to export-led growth. Most of the labour is concentrated in agriculture sector in Pakistan, India, and Bangladesh. This verifies that these workers are working at subsistence level and getting the lowest wage. Due to which, most workers do not work at their potential. This could be one of the factors why agricultural productivity is very low despite having large number of labour share. More liberalized trade in this sector would be beneficial. Pakistan, India and Bangladesh, should focus more taking advantage of their expertise in agriculture sector rather that diversifying into manufacturing at cost of decreased competitiveness. This was one of the reasons why Pakistan and Bangladesh have lagged behind while India has achieved unprecedented growth with its expertise on information technology. The idea is to attain economies of scale through learning by doing.

Such policies should be adopted that would encourage imports to keep the domestic prices at reasonable levels along with reduction in the export subsidies so as to promote domestic exports in foreign markets, creating niche. In this way trade liberalization can lead to employment generation and economic progress, beside a means for technological advancement. Government’s role is crucial for the social impact for any society. Government should charge taxes and duties from imports so as to support the domestic firms and bringing them at par. Subsidies on the exports should be minimised so that firms are encouraged to export more and labour to work at full efficiency. In this situation, the governments of the economies have got to play restricted role. Government should play their role in defining the clearly the property rights for the proper facilitated bargaining among the groups. Governments should provide institutional and legal frameworks for the economic agents to work with. It would be helpful in contract enforcement. Developing countries of SAARC must diversify their output through value addition rather than exporting the raw or semi-raw products. For example in Textiles, Pakistan has very limited number of products such as Towels, Bed sheets etc. It should expand its product variety more, to penetrate in the foreign market.

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