Effects of International Trade on Economic Growth: The Case Study of Pakistan

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Effects of International Trade on Economic Growth: 
The Case Study of Pakistan

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Abstract
The study examines the impact of total exports to GDP ratio, imports to GDP, terms of trade, 
trade openness, investment to GDP ratio, and inflation on the economic growth of Pakistan. The 
empirical analysis is conducted by using time series data from 1973-2010. Chow test is used to 
test the structural break and model fitness. The OLS (Ordinary Least Square) technique is used to 
detect the relationship between exogenous variables and endogenous variable. The estimated 
results show that explanatory variables have positive and significant impact on the economy of 
Pakistan. The results also show that an increase in the import of raw materials, the production, 
employment and output of the country is boosted up. Similarly, Trade openness has also positive 
and significant influence on the economy of Pakistan. It concludes that international trade may 
play an important role to enrich the economy of Pakistan.

Keywords: Total Exports to GDP Ratio, Imports to GDP Ratio, Terms of Trade, Trade Openness, 
Investment to GDP Ratio, Inflation, Pakistan
Introduction
The word trade has been defined in the Oxford Advanced Learner dictionary as “the activity in which people are buying and selling or exchanging the goods and services” (Kumar, 2009). International trade is the exchange of capital, goods, and services across international borders. It is a system where the goods and services are advertised, sell and switched between two or more than two countries through import and export. A trade theory describes that there is generally a positive association among openness, export to GDP ratio, investment to GDP ratio and inflation. There are several ways by which find that openness, export to GDP ratio, investment to GDP ratio influence economic growth (Iqbal, et al., 1998).

In Pakistan’s economy trade openness do not have significant on international trade but the country meet low diversification in export division and production division. This creates unpleasant shocks and upsets in world markets. Consequently, economic performance decline over the time.

Exports of Pakistan are mostly based on the agriculture sector and it is a largest sector in Pakistan. Nearly 23 percent of Pakistan’s national income (GDP) and 42 percent of labor force is associated with agricultural sector. This sector also supplies raw stuff to food, chemical, and technical industries of Pakistan (Khan, 1997).

Objective
To see the effects of inflation, trade openness, exports and imports on economic growth of Pakistan.

Organization of the Paper
Resting this paper is shaped as under: Review of literature is presented in section II Methodology and data will be discussed in section III. In section IV and last, the conclusion of the study and suggestions will be discussed.

Review of Literature
Michaely (1977) finds a optimistic association sandwich between export and growth of economics. Greenway and Sapsford (1994), Yamin et. al (1995) found that a little support for positive impacts of liberalization on trade.

Mendoza (2000) examines the affiliation among openness, exports to GDP ratio and economic enlargement for five ASEAN nations, and detected co integration between openness, exports to GDP ratio and economic expansion for all nations. Ahmad (2000) stated the result of long-term investigation in the computerized exports management. He discussed the Pakistan’s export trend and problem of export facing Pakistan and how to remove the difficulties of exports in Pakistan how it manage the export through the computer.

Mustafa, et al (2001) assessed the implication of globalization for poverty and agricultural in Pakistan They suggested that there is adverse impact of globalization on agriculture and poverty.
Hada and Williamson (2003) find the empirical evidence between economic growths, terms of trade and exports over the period 1870-1940. They find strong disassociation between economic growths, terms of trade and exports. Evans (2007) argues that openness on inflation create positive effect in international market through monetary and fiscal policies. Hanif and Jafri (2008) suggest that foreign debt has positive impact on the Pakistan’s textile sector and agricultural sector both in the short and the long run.

Sheikh and Rahpoto (2009) they analyzed the gains of Pak-India trade and probable economic costs in exporting a variety of consumable commodities like dates, leather and cotton made garments in two scenarios. They found an appraisal of the implications of SAFTA which allow the participating countries to achieve larger economics of scale in production, increase competitiveness, attain specialization and diversify their exports. It was suggested that under the combined policy reform of the SAFTA Pakistan would experience the maximum welfare gain.

Data & Methodology
The data for macroeconomics variables such as total exports to GDP ratio, imports to GDP, terms of trade, trade openness, investment to GDP ratio, and inflation have been obtained from different issues of Economic Survey of Pakistan.

Durbin Watson d test and Breusch-Godfray tests are used to detect fitness of model. The structural breaks of data are determined by Chow test. Jarque-Bera test for the normality in residuals and White’s test is used for heteroscedasticity.

To examine whether a time series has a unit root problem, In this regard Augmented Dickey-Fuller (ADF) unit root test is used to detect the status of unit root. To implement the ADF test following regression will be estimated:

$$\Delta Y_t = \beta_1 + \beta_2 t + \delta Y_{t-1} + \sum_{i=1}^{m} \Delta Y_{t-i} + \epsilon_t$$

Where $\epsilon_t$ is a pure white noise error term and where $\Delta Y_{t-1} = (Y_{t-1} - Y_{t-2})$, the empirically number of lagged difference terms to include is often determined, so that it can be concluded that the above equation shows that the error term is serially uncorrelated. If the t-statistics are less than the critical value than the null hypothesis of the unit root ($\Phi = 0$) cannot be rejected but if the t-statistics are greater than the critical values than null hypothesis of the unit root can be rejected.

The following test is used to judge the fitness of model.

**Coefficient of Determination $R^2$**

$R^2$ shows the degree of variation in the dependent variable due to the variation in the explanatory variables. $R^2$ is given as below:

$$R^2 = \frac{ESS}{TSS} = 1 - \frac{RSS}{TSS}$$

**Adjusted $R^2$**

The term adjusted means adjusted for the degree of freedoms associated with the sum of
squares. As the number of explanatory variables increases, adjusted $R^2$ increases less than unadjusted $R^2$. It can be calculated as

$$\bar{R}^2 = 1 - \sum \frac{\hat{\mu}^2}{(n-k)} \sum \frac{y_i^2}{(n-1)}$$

Where $k =$ number of parameters and intercept term in a model. Adjusted $R^2$ can be negative. In case this case when it is negative, it is considered zero.

**White Test**

The white test can be a test of pure heteroscedasticity or specification error or both. It has been argued that if no cross product terms are present in the white test procedure, then it is a test of pure heteroscedasticity. If cross-product terms are present, then it is a test of both heteroscedasticity and specification bias (Gujrati, 2004).

**Durbin-Watson d Test**

D.W test mathematically defined as:

$$d = \frac{\sum_{t=2}^{n} (u_t - u_{t-1})^2}{\sum_{t=1}^{n} u_t^2}$$

This is simply the ratio of sum of the squared difference in successive residuals to the RSS. This test is used to find problem of autocorrelation in the model.

**Breusch-Godfray Test**

To avoid some of the drawbacks of the Durbin Watson d test of the autocorrelation, Breusch and Godfray have constructed a test of autocorrelation that allows for: (a) non stochastic regressors, such as the lagged values of the regressends; (b) higher order auto regressive schemes such as AR1, AR2. (Gujrati, 2004).

$H_0 =$ there is no autocorrelation in the error term

$H_1 =$ there exists autocorrelation in the error term

**Jarque-Bera (JB) Tests of Normality**

The Jarque-Bera test is used to detect normality of model. This test first finds the skewness and kurtosis of the OLS residuals. The statistics of the model is given as below:

$$JB = n \left[ \frac{S^2}{6} + \frac{(K-3)^2}{24} \right]$$

Where $n =$sample size, Skewness = $S$ and kurtosis coefficient = $K$. For distribution of variable, $S=0$ and $K=3$, therefore the JB test of normality is a test of joint hypothesis. as a result, Skewness and kurtosis are 0 and 3 respectively. The worth of the JB statistics is considered to be 0 in this case (Gujrati, 2004).
Chow Break-point Test
In econometrics, the Chow test is most commonly used in time series data to detect the presence of a structural break (Gujrati, 2004). Hypothesis about structural break, given as

\[ H_0 = \text{there is no structural break} \]
\[ H_1 = \text{there exists structural breaks} \]

**Specification of the model 1 is given as:**

\[ Y = \beta_0 + \beta_1 XR + \beta_2 IR + \beta_3 TOT + \beta_4 P + \beta_5 TOT + \mu \]  

Where

- \( Y \) = GDP growth
- \( XR \) = total exports to GDP ratio
- \( MR \) = total imports to GDP ratio
- \( TOT \) = terms of trade [(export prices + import prices)/GDP]
- \( TO \) = trade openness [(TX+TM)/GDP]
- \( IR \) = investment to GDP ratio
- \( P \) = inflation

The Augmented Dickey Fuller test is used to detect level of stationary and the results of AD are presented in Table No.1:

<table>
<thead>
<tr>
<th>Variables</th>
<th>Level with intercept</th>
<th>1st difference without intercept</th>
</tr>
</thead>
<tbody>
<tr>
<td>Y</td>
<td>-3.321</td>
<td>-5.802</td>
</tr>
<tr>
<td>XR</td>
<td>-3.195</td>
<td>-4.959</td>
</tr>
<tr>
<td>MR</td>
<td>-3.171</td>
<td>-4.686</td>
</tr>
<tr>
<td>TO</td>
<td>-3.170</td>
<td>-4.749</td>
</tr>
<tr>
<td>TOT</td>
<td>-2.341</td>
<td>-5.726</td>
</tr>
<tr>
<td>IR</td>
<td>-2.885</td>
<td>-5.037</td>
</tr>
<tr>
<td>P</td>
<td>-3.891</td>
<td>-7.085</td>
</tr>
</tbody>
</table>

The critical values -4.23, -3.53 and -3.20 at 1%, 5%, and 10%, respectively

All variables are stationary except TOT and IR.

The results of estimation first model 1 are reported as under:

\[ Y = -8.306 + 0.32XR + 0.18IR + 0.05P + 0.23 TO + 0.31 TOT \]  

(8.40) (1.919) (3.21) (0.665) (3.32) (0.765)

R-squared = 0.238 F-statistic = 3.47
Adjusted R-squared = 0.168 D.W = 1.91

Results of the model are somewhat satisfactory and signs of the coefficients are supporting the previous research findings. The coefficients of all variables in above regression are statistically
significant except P which is not statistically significant even at 10% level. The sign of export to GDP ratio shows that there is positive relationship between export to GDP ratio and GDP growth. The justification for this positive relationship is that as the export to GDP ratio increases which raises GDP.

The slope of exports suggests that 1 unit increase in exports leads to 0.32 units boost in GDP growth. The investment to GDP ratio has also positive relationship with GDP growth. Its slope coefficient indicates that 1 unit increase in investment to GDP ratio leads to 0.18 units enlarge in GDP growth. Inflation affects GDP growth in positive manner as indicated by the sign but it is insignificant. The value of $R^2$ is 0.238 which shows that about 23.7% variation in GDP growth is explained by the exports, imports and other factors. Similarly, TO is significant and has positive impact on economic growth, while TOT is insignificant but it has appropriate sign with reference to model.

The value of Durbin-Watson test is close to 2, which shows there is no auto correlation exists. Similarly Jarque-Bera Test indicates that the probability of JB statistics is significance which shows that the error term is normally distributed.

Result of Jarque-Bera test

![Jarque-Bera Test](image)

Result of White Heteroscedasticity test

<table>
<thead>
<tr>
<th>White Heteroscedasticity Test</th>
<th>F-statistic</th>
<th>Probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obs*R-squared</td>
<td>0.308</td>
<td>0.927</td>
</tr>
</tbody>
</table>

Results of White Heteroscedasticity test show that the probability of the model is insignificant, so that the null hypothesis accepted as the error term is homoscedastic and model is fit for analysis.

Table No. 2 Result of Chow test:
Chow Breakpoint Test 1995

<table>
<thead>
<tr>
<th>F-statistic</th>
<th>Probability</th>
<th>Log likelihood ratio</th>
<th>Probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.953</td>
<td>0.065</td>
<td>6.086</td>
<td>0.0476</td>
</tr>
</tbody>
</table>

Table No. 2 shows that, there is no structural break in the analysis data over the period from 1973-2010, except in 1995.

Table No. 3 Breusch-Godfrey serial correlation (LM) test

<table>
<thead>
<tr>
<th>Breusch-Godfrey Serial Correlation LM Test:</th>
</tr>
</thead>
<tbody>
<tr>
<td>F-statistic</td>
</tr>
<tr>
<td>Obs*R-squared</td>
</tr>
</tbody>
</table>

The Breusch-Godfrey test is applied to detect the serial correlation in the data. The results are given in the Table No.3 which shows that there is no serial correlation in the data.

**Specification of the model 2 is given as**

\[ Y = \beta_0 + \beta_1 MR + \beta_2 IR + \beta_3 P + \mu \quad (2) \]

\[ Y = 6.36 + 0.18 MR + 0.16 IR + 0.23 P \]

(1.55) (3.04) (1.99) (3.12)

R-squared = 0.236 Adjusted R-squared = 0.166

D.W = 1.91 F-statistic = 3.45

Results of the model are somewhat satisfactory and signs of the coefficients are supporting the prior findings. The coefficients of all variables in above regression are statistically significant. The sign of import to GDP ratio shows that there is positive relationship between import to GDP ratio and GDP growth; this is so because growth of GDP raises income households.

The slope of import suggests that 1 unit increase in exports leads to 0.18 units boost in GDP growth. The investment to GDP ratio has also positive relationship with GDP growth but it is statistically significant. Its slope coefficient indicates that 1 unit increase in investment leads to 0.16 units enlarge in GDP growth. Inflation affects GDP growth in positive manner as indicated by the sign. The value of R² is 0.236 which shows that about 23.7% variation in GDP growth is explained by the exports, imports and other factors.

The value of Durbin-Watson test is 1.91 which is close to 2, which shows that there is no auto correlation. Similarly Jarque-Bera statistics is insignificance which shows that the error term is normally distributed.

Jarque-Bera test
Table No. 4 Breusch-Godfrey serial Correlation LM Test:

<table>
<thead>
<tr>
<th></th>
<th>Breusch-Godfrey Serial Correlation LM Test:</th>
</tr>
</thead>
<tbody>
<tr>
<td>F-statistic</td>
<td>0.315220</td>
</tr>
<tr>
<td></td>
<td>Probability 0.731</td>
</tr>
<tr>
<td>Obs*R-squared</td>
<td>0.734184</td>
</tr>
<tr>
<td></td>
<td>Probability 0.692</td>
</tr>
</tbody>
</table>

The Breusch-Godfrey test is used to detect the serial correlation in the data. The results are given in the Table No. 4 which shows that there is no serial correlation in the data.

Table No. 5 White’s heteroscedasticity test

<table>
<thead>
<tr>
<th></th>
<th>White Heteroskedasticity Test:</th>
</tr>
</thead>
<tbody>
<tr>
<td>F-statistic</td>
<td>0.275278</td>
</tr>
<tr>
<td></td>
<td>Probability 0.944313</td>
</tr>
<tr>
<td>Obs*R-squared</td>
<td>1.922210</td>
</tr>
<tr>
<td></td>
<td>Probability 0.926712</td>
</tr>
</tbody>
</table>

The results in Table No. 5 shows that the probability of the model is insignificant, so that the null hypothesis accepted as the error term is homoscedastic and model is fit for analysis.

Table No. 6 Chow Breakpoint Test

<table>
<thead>
<tr>
<th></th>
<th>Chow Breakpoint Test: 1995</th>
</tr>
</thead>
<tbody>
<tr>
<td>F-statistic</td>
<td>2.463889</td>
</tr>
<tr>
<td></td>
<td>Probability 0.1001</td>
</tr>
<tr>
<td>Log likelihood ratio</td>
<td>5.143210</td>
</tr>
<tr>
<td></td>
<td>Probability 0.0764</td>
</tr>
</tbody>
</table>

Series: Residuals
Sample 1973 2009
Observations 37

Mean -1.20E-15
Median 0.262471
Maximum 3.023947
Minimum -3.247538
Std. Dev. 1.775640
Skewness -0.002613
Kurtosis 1.996274
Jarque-Bera 1.553218
Probability 0.459963
The results in Table No. 6 show that, there is no structural break in the analysis data over the period from 1973-2010, except in 1995.

Conclusion and Discussions
The central objective of this research is to examine the effect of international trade on economic growth through empirical analysis using annual data in Pakistan over the period 1973 to 2010. Results of the model 1 and model 2 are quite satisfactory and signs of the coefficients are supporting the previous research findings. The coefficients of all variables in above regression are statistically significant except inflation which is not statistically significant even at 10% level. Results of the model are somewhat satisfactory and signs of the coefficients are supporting the previous research findings. The coefficients of all variables in above regression are statistically significant except P which is not statistically significant even at 10% level. The sign of export shows that there is positive relationship between export and GDP growth. The justification for this positive relationship is that as the export increases which raises GDP.

The slope of exports suggests that 1 unit increase in exports leads to 0.32 units boost in GDP growth. The investment to GDP ratio has also positive relationship with GDP growth and is statistically significant. Its slope coefficient indicates that 1 unit increase in investment leads to 0.18 units enlarge in GDP growth. Inflation affects GDP growth in positive manner as indicated by the sign but it is insignificant. The value of $R^2$ is 0.234 which shows that about 23.7% variation in GDP growth is explained by the exports, imports and other factors. In model 2 the sign of import to GDP ratio shows that there is positive relationship between import and GDP growth, this is so because growth of GDP raises income households. The slope of import suggests that 1 unit increase in imports leads to 0.18 units boost in GDP growth. The investment to GDP ratio has also positive relationship with GDP growth and is statistically significant. Its slope coefficient indicates that 1 unit increase in investment leads to 0.16 units enlarge in GDP growth. Inflation affects GDP growth in positive manner as indicated by the sign.

In nut shell, international trade has positive impact on the economy of Pakistan. The economy Pakistan can be better if Government should adopt multipurpose strategies such as improvement in tax and revenue structure, improving fiscal, monetary policies and structural adjustments policies and eradicate anticompetitive market practices. Moreover, Govt should decrease the imports of costly products with suitable policies and prefer to prepare all required things inside the country.

References


