Model for Improving The Growth of Real Gross Domestic Product of Pakistan

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Abstract

The purpose of this paper is to understand the impact of export, investment and foreign economic assistance (foreign aid) variables on RGDP of Pakistan, in order to identify and implement appropriate strategies that will have a significant impact on overall economic growth. The time series data obtained from secondary sources, have been taken to investigate relationship exists among the variables, during the period of 1990-2020. It included data from State Bank Of Pakistan(SBP), Pakistan Bureau Of Statistics(PBS), Pakistan Economic Survey(PES). First of all "Augmented Dickey and Fuller(1979)[ADF]" test was applied to check the stationary of data, which showed that all variables are stationary at the first difference. EG-ECM methodology was applied to check the short-run and long-run estimation. Based on results of regression analysis, it is concluded that investments (INV) has significant impact on RGDP in both short-run and long-run. Export (X) and foreign economic assistance (FEA) have no impact in short-run, however showed significant impact in long-run. Based on the findings, the study suggests that government should facilitate the exporters to export semi-finished or finished goods, rather than raw material in order to increase their incentive and providing employment opportunities to locals. The State Bank Of Pakistan (SBP) and ministry of finance should focus on promoting INV through savings policies, in order to meet the gap between savings and investments. Pakistan should reduce his rely on foreign funding and needs to improve his domestic savings and investment to gain financial independence. FEA should only be use for productive purposes, infrastructural development and for the betterment of people.

Keywords : Export, Investment, Foreign Economic Assistance, RGDP

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INTRODUCTION

Growth in the economy matters for everyone including individuals, businesses, charities and the government. It is of the most powerful instrument for reducing poverty and improving the quality of life in developing countries like Pakistan. Highlighting the importance of economic growth, Dani Rodrik stated in his book: "Historically nothing has worked better than economic growth in enabling societies to improve the life chances of their members, including those at the very bottom" (One Economics, Many Recipes, 2007). According to Department for International Development (DFID), "The central lesson from the past 50 years of development research and policy is that economic growth is the most effective way to pull people out of poverty and deliver on their wider objectives for a better life". Economic growth typically refers to gross domestic product (GDP) growth but in broad terms, an increase in real gross domestic product (RGDP) is interpreted as a sign that the economy is doing well (IMF-Finance & Development, 2020).

There is general agreement in the economics literature that resource flows among countries in response to market incentives enhance global economic efficiency and welfare in both rich and poor countries (Ruttan, 1989). There are many potential factors that influence Pakistan's economic growth (RGDP), but this study only looks at a few of the most contentious ones, such as export, investment, and foreign economic assistance (foreign aid). An assessment of the role of exports in economic growth is of obvious importance in developing countries like Pakistan. It is considered as important catalyst for economic growth. The standard neoclassical trade argument and "two-gape" models of development would postulate a substantial positive impact of exports and trade on economic performance due to better allocation of resources and strengthening foreign reserves but the Marxist or the Neo-Marxist stances may treat trade as one mechanism for exploitation of the less developed countries by the industrialized West (R Rati, 1985). A higher level of exports might contribute to economic growth because export revenues provide an important source of foreign exchange, which is crucial when domestic savings are insufficient to fund goods imports (Shawa, M. J., & Grafoute, A. Y., 2014). Export growth might trigger economic growth through the expansion of the efficient market size, bringing in substantial economies of scale that speed up the rate of capital formation and technological changes. No doubt exports are the main source of foreign exchange reserves but Pakistan imports more than exports. As imports continue to surge, Pakistan's trade deficit increasing at accelerated pace. Pakistan is unable to maintaining the appropriate balance between imports and exports.

The role of domestic saving and investment in promoting economic growth has received considerable attention in Pakistan and also in many countries around the world. It cannot be denied that an increase in aggregate savings would boost investment and promote economic growth. Investment in the form of capital accumulation provides an extra revenue stream for countries like Pakistan, allowing for more options for production and productivity. Savings are the most important factor in increasing in-country capital and developing countries encourage domestic savings in order for capital to be invested in the most productive practices. The central idea of Lewis's (1955)

traditional theory was that an increase in saving would accelerate economic growth, while the early Harrod-Domar models specified investment as the key to promoting economic growth (Sekantsi, & Kalebe, 2015). A higher degree of self-reliance is a desirable long-term goal of any economy, but unfortunately, Pakistan is included in those countries, which rely on external sources due to deficiencies in domestic resource mobilization (Ahmad & Atiq, 2006). Pakistan's saving performance is not very impressive relative to other countries in the region that have experienced sustained high growth. Therefore, Pakistan has relied heavily on foreign capital to fill the gap between domestic saving and domestic investment (Alam & Butt, 2006). Investment resources in most of the developing countries like Pakistan mostly come from abroad, especially in the form of foreign direct investment or foreign economic assistance(loans, grants or aid). However, high reliance on external sources limits their independence and put more pressure on economy if these resources are not use for productive purposes. Therefore it is important for a developing country like Pakistan, to understand the nature of savings and investment relationship and their impact of economic growth.

Foreign Economic Assistance (foreign aid) is also a source of foreign cash inflows like export. It has also been argued that in the presence of capital market imperfections, transfers of resources on commercial terms from developed country governments to developing country governments, either directly or through multilateral agencies, can be expected to benefit both developed and developing countries (Ruttan, 1989). In the past, two arguments have been used to justify transfers that include a grant component. One

set is based on the donor country's economic and strategic self-interest. The second is based on residents of wealthy countries' ethical or moral responsibility towards the residents of poor countries (Ruttan, V. W.,1989). FEA develops the economy by providing infrastructures and other developmental projects (Kolawole, 2013). Increasing the dependence on foreign funds always a problem for Pakistan. FEA are mostly in the form of loans which increases the burden of debt and put our economy under more pressure if it is not used for productive purposes. It is important to evaluate the extent to which growth could be propelled by foreign economic assistance in Pakistan which ranked as world 124th corrupt country (Transparency International, 2020).

Like almost every country around the globe, Pakistan's economy suffered in 2020. COVID-19 closures and lock-downs to limit the spread of the virus, has contributed a lot in growing unemployment and poverty. Annual economic growth in calendar year 2018 was 5.8% but that figure plunged to 0.99% a year later, according to the World Bank's data, 2021. The coronavirus pandemic dealt another blow to the economy and in 2020, growth slipped further to 0.53%(World Bank, 2021). Per capita income fell from US\$1625 to US\$1325 (S A Zaidi, 2021). It is widely believed that Pakistan as a faster growing population country, needs an economic growth rate of over 7% to ensure its unemployment doesn't increase faster (B Memon, 2020), but the growth rates during the last four decades have been around 5% (IMF, 2019). In order to develop strategies and policy frameworks that will help Pakistan's economy achieve its sustainable growth objectives, policymakers and academics must understand the impact of export, investment and foreign economic assistance (foreign aid) variables on RGDP growth in order

to identify and implement appropriate strategies that will have a significant impact on overall economic growth. Therefore, determining the relationship between RGDP, export, investment, and foreign economic assistance (foreign aid) is critical in understanding the country's economic performance, particularly in Pakistan.

A large number of studies have previously analyzed this topic. However, findings of these studies varies considerably according to the theoretical assumptions, empirical models chosen, estimation techniques adopted, set of countries and the time span used for analysis. M Afzal (2006) investigated the direction of causation between GDP representing economic growth, exports and its different categories, imports and world income. A strong and stable relationship between GDP and exports and bi-directional causality between manufactured exports and GDP has been found. Rana (1985) calculated an export-augmented production function for 14 Asian emerging nations, including Pakistan. The research suggests that exports help to boost economic growth. Samiullah et al. (2009) re-examined the ELG hypothesis in Pakistan by using yearly data from 1970 to 2008, . The findings of co-integration show that a rise in export leads to economic growth in Pakistan. Khalifa (1997) examined the link between exports and economic growth for the period 1973 to 1993 and confirmed the hypothesis by establishing a positive and substantial association between the export and economic growth. Mah (2005) used the relevance of the error correction term, ECt-1, to investigate the long-run causality between export and growth. This analysis found that export expansion is insufficient to explain real economic growth patterns. Pazim (2009) assessed the validity of the "export-led hypothesis" in three BIMP-EAGA nations (namely, Indonesia, Malaysia, and the Philippines) by using Panel data analysis . According to the results of the one-way random effects model, there is no significant association between GDP and export in these nations. Lorde (2011) used cointegration and Granger causality to assess the validity of the export-led growth hypothesis for Mexico from 1960 to 2003. Only a short run causation from export to growth is revealed experimentally. In the long run, he notices inverse correlation between economic growth and exports. Faridi, M. Z. (2012) explored the contribution of agricultural exports to economic growth in Pakistan. By employing Johansen co-integration technique for the period 1972 - 2008, concluded that the agricultural exports have negative and significant effect on economic growth.

Le and Suruga (2005) investigated the influence of public investment and FDI on economic growth . Using panel data from 105 developed and developing countries from 1970 to 2009. According to their conclusion, both public investment and FDI have a favorable influence on economic growth. Nhung and Nguyen (2017) attempted to explore the contribution of saving and investment of economic growth of Vietnam from 1987 to 2015. By using Auto Regressive Distributed Lag Bounds Testing (ARDLBT) model, the researchers found that domestic savings and domestic investment do not have any impacts on economic growth in the short-run but have impacts in the long-run. Bouchoucha, Najeh, and Bakari (2001) investigated the influence of domestic and foreign direct investment on Tunisian economic growth from 1976 to 2017. This study is based on the Auto-Regressive Distributive Lags (ARDL) approach and Bound testing approaches to the analysis of level

relationships. According to the findings, domestic investment and foreign direct investment, have a long-term negative impact on economic growth.

Islam (1972) recognized the link between foreign aid and economic growth in the context of Pakistan, revealing that aid helps create domestic savings and investment. Although it raised the rate of inflation to some extent, still it played a important role in the enrichment of GDP. Ahmed et.al (2011) analyzed the effects of foreign aid on Pakistan's economic growth. The Time Series Method was employed in this study, which used data from 1990 to 2010. Foreign aid was the independent variable, whereas GDP was the dependent variable. According to the findings of the study, foreign aid has a positive impact on Pakistan's economic development. MM (2016) used the DOLS model to uncover the impact of aid on advancement from 1976 to 2014. According to the empirical findings, aid and growth have a negative relationship. Mallik (2008) looked at the six poorest countries in the SSA and found that, despite receiving foreign assistance, their real per capita income declined or stayed the same and that five of the six countries had a negative growth relationship with foreign assistance. Dreher and Langlotz (2015) used an excludable instrument to look at the influence of aid on growth in 96 countries, over the time period 1974 - 2009. They came to the conclusion that foreign aid had no effect on growth. Liew et al. (2012)used pooled ordinary least squares, random effect, and fixed effect models to investigate the effects of foreign aid on economic growth in East African countries between 1985 and 2010. They discovered that foreign aid and economic growth had a negative link.

In the light of previous available literature, it can be inferred that previous findings are contradictory to each others. Previous studies can be divided into two school of thoughts, where one school of thought suggests positive while other suggests negative impact of export, investment and foreign economic assistance on economic growth of Pakistan, so there is still mixed opinion. More work is needed to get reliable estimates. In order to get reliable estimate, this article has taken Real Gross Domestic Product (RGDP) as the dependent variable and Export, Investment and Foreign Economic Assistance as independent variables. Unlike most of previous studies, real gross domestic product (RGDP) as dependent variable as RGDP is a more accurate reflection of the output of an economy than nominal GDP. Economists track RGDP to determine the rate at which an economy is growing without any of the distorting effects of inflation. The growth rate of RGDP is often used an indicator of the general health of economy (Callen, 2012). Changes RGDP do a reasonable job in capturing changes in economic well-being (Dynan & Sheiner, 2018). An increase in RGDP is interpreted as a sign that economy is doing well (Callen, 2012). Moreover, this present study will use the latest and more reliable data, which is mainly collected from State Bank of Pakistan (SBP-Central Bank). Most of previous research have used World Bank data. The World Bank estimates for remittances are far from accurate, due to the methodological challenges.(Alvarez et al., 2015; World Bank, 2016; Plaza and Ratha, 2017). Finally, Error Correction Model (ECM) will apply to estimate the long run and short run co-integration between the dependent and the independent variables. The ECM approach is unique because it provides evidence for the short-run and long-run relationships between the variables and the direction and rate at which

disequilibrium between the variables would be corrected over time (Abraham & Ahmed, 2011).

This study comprises of four main sections. section 1 presents the introduction of the study, section 2 presents the research methods which is followed by section 3 that presents the results and discussion, section 4 presents the conclusion.

METHOD

All time series data which analyzed here was obtained from secondary sources, varies from 1990 to 2020. The researcher used online websites and databases to access the data which included data from State Bank Of Pakistan(SBP), Pakistan Bureau Of Statistics(PBS), Pakistan Economic Survey(PES) and World Bank etc. The research used various methods such as the unit root test for stationary analysis, Engle Granger Error Correction Model (EG-ECM) for regression analysis to assess the reliable affect and short-run and long-run relationship between the variables.

The basic model is formulated as follow:

$$RGDP = f(X, INV, FEA) \qquad (1)$$

Where RGDP is real gross domestic product, X is export, INV is investment and FEA is foreign economic assistance.

First of all, unit root test will apply to examine the stationery of time series data at level and first difference. It is a pre-requisite for time series data analyses. This study will performed conventional unit root tests by using Augmented Dickey and Fuller(1979)[ADF] methodology, which is most commonly used. The data is stationary when arithmetical properties, for instance mean, variance, covariance/ autocorrelation, do not change over time (Arsalan, 2019).

The ADF test is based on the following regression,

$$\Delta Y_t = \alpha + \delta y_{t-1} + \mu_t(2) \qquad (2)$$

Where α is constant, δ is slope coefficient, t is a linear time trend, and μ is the error term.

ECM will apply to estimate the long run and short run co-integration between the dependent and the independent variables. The ECM is used to test model specifications as well as the appropriateness of data collection. The model specifications and data collection methods are appropriate if the ECT (Error Correction Term) parameter is statistically significant (A Lamah, 2021).

The conditions of the EG-ECM are mention below;
i.   All variables are stationary at level, I(0);
ii. All variables are stationary at the first difference, I(1);
iii. All variables should be co-integrated.

The EG-ECM is employed for the analysis since the model provides complete information on the dynamic short-run and long-run connections among the co-integrating variables.

The basic model, or the long-run model, is formulated as follow:

$$RGDP_t = \beta_0 + \beta_1 X_t + \beta_2 INV_t + \beta_3 EFA_t + e_t \qquad (3)$$

Next, the basic model is transformed into Error Correction Model form, or the short run model, as follow:

$$D(RGDP)_t = \alpha_0 + \alpha_1 D(X)_t + \alpha_2 D(INV)_t + \alpha_3 D(FEA)_t + \varepsilon_t \qquad (4)$$

RESULT AND DISCUSSION

The actual determination of whether a variable is stationary or non-stationary is based upon the results of unit root tests. Table 1 shows the empirical results of the ADF test. The obtained results show that all variables are not stationary at level, as all the probability values of all variables are more than 10% or 0.10. In addition, all variables are stationary at the first difference, as all the probability values of all variables are less than 10% or 0.10. The results indicate that it fulfilled the first two conditions of EG-ECM.

Table 1. Unit Root Tests for Level and 1st Difference

Variables	Level, I(0)	1st Difference, I(1)
RGDP	0.9394	0.0055
X	0.7138	0.0005
INV	0.8537	0.0087
FEA	0.9830	0.0001

Source: data processed

The next step is to check the co-integration test. Table 2 shows the empirical results of the co-integration test. The obtained results show that the residuals are stationary at level or I(0). The test indicates that all variables in the model are co-integrated, which means that the model has a long-run relationship. The result suggests that the model fulfilled the 3rd condition of EG-ECM, and we can proceed to EG-ECM.

Table 2. Co-Integration Test

		t-Statistics	Prob.*
Augmented Dickey-Fuller test statistics		-2.543977	0.0128
Test critical values:	1% Level	-2.644302	
	5% Level	-1.952473	
	10% Level	-1.610211	

*Mackinnon (1996) one-sided p-values.
Source: Data processed

As our model fulfill all three conditions of EG-ECM, the next step is to check the short-run estimate of ECM(-1). Table 3 shows the empirical results of the ECM(-1) at 1%, 5% and 10% of critical values for variables. The obtained results shows that the export (X) also has direct but statistically insignificant impact on RGDP. The coefficient of X is 1.127021 which is positive value and p-value of X is 0.3015, which is greater than 0.10 [0.3015 > 0.10], so it is concluded that X has no impact on RGDP in short run. Investment (INV) has a positive and statistically significant impact on RGDP. The coefficient of INV is 3.502735 which is a positive value and p-value is 0.0000 which is less than 0.1, statistically significant at 1% of critical value. This output implies that in the short run, if there is an USD 1 increase in INV, the RGDP will rise by USD 3.50, assuming ceteris paribus. Therefore, it is concluded that in short-run, INV is positively and directly related to RGDP, and it creates positive effect on RGDP. Foreign Economic Assistance (FEA) has a positive but insignificant impact on RGDP. The coefficient of FEA is 0.899642 which is a positive value and p-value is 0.5621 which is greater than 0.10 [0.5621 > 0.10], therefore X has no impact on RGDP in short run. The coefficient of ECT shows that the speed of adjustment towards equilibrium have negative sign and statistically significant which implies a convergence from short to long run. The speed of adjustment towards equilibrium is 0.257190, which means that 0.25 or 25% of this disequilibrium is corrected in between one year. The values of R-squared in the short-run ECM is 0.6366080 which indicates that 0.63 or 63% of the variance of the dependent variable being studied is explained by the variance of the independent variables, while the remaining 37% is explained by the variance of variables outside

the model. Table 3.3 provides more information about the results of short-run ECM.

Table 3. Results of Short-Run ECM

Dependent Variable (DRGDP)		
Variable	Coefficient	Prob.
DX	1.127021	0.3015
DINV	3.502735	0.0000***
DFEA	0.899642	0.5621
ECT_{t-1}	-0.257190	0.0665*
Constant	2.650000000	0.1531
R-squared		0.636608

***significance at p ≤ 0.01; **significance at p ≤ 0.05; *significance at p ≤ 0.10.

Source: Data processed

This study also uses the long-run ECM to understand the long-run relationships between the variables. Table 4 shows the empirical results of the long run ECM at 1%, 5% and 10% of critical values for variables. The obtained results show that the Export (X) has a positive and statistically significant impact on RGDP. The coefficient of X is 4.854539 which is a positive value and p-value is 0.0002 which is less than 0.1, statistically significant at 1% of critical value. This output inferred that in the long run, if the X increases USD 1, the RGDP will increase by USD $4.85, assuming ceteris paribus. The observed values specify that in long-run, X positively and directly related to RGDP. Investment (INV) has a positive and statistically significant impact on RGDP. The coefficient of INV is 3.221867 which is a positive value and p-value is 0.0002 which is less than 0.1, statistically significant at 1% of critical value. This output implies that in the long run, if INV increase by USD 1, it will cause an increase of USD 3.22 in RGDP, assuming that other variables are equal.

This result suggests that in long-run, INV is positively and directly related to RGDP, and it creates positive effects on RGDP accelerate the economic growth. Foreign Economic Assistance (FEA) has direct and statistically significant impact on RGDP. The coefficient of FEA is 4.889542 which is a positive value and p-value is 0.0042 which less than 0.1, statistically significant at 1% of critical value. The result indicates that in the long run, if FEA increase by USD 1, it will cause an increase of USD 4.88 in RGDP, assuming that other variables are equal. This result suggests that in long-run, FEA is positively and directly related to RGDP and it creates positive effects on RGDP. The values of R-squared of the long-run ECM is 0.978775 which indicates that 0.97 or 97% of the variance of the dependent variable being studied is explained by the variance of the independent variables while the remaining 3% is explained by the variance of variables outside the model. Table 3.4 provide more information about the results of long-run ECM.

Table 4. Result of Long-Run ECM

Dependent Variable (RGDP)		
Variable	Coefficient	Prob.
X	4.854539	0.0002***
INV	3.221867	0.0002***
FEA	4.889542	0.0042
Constant	-2.8100000000	0.0641*
R-squared		0.978775

***significance at p ≤ 0.01; **significance at p ≤ 0.05; *significance at p ≤ 0.10.

Source: Data processed

Findings of this study suggests that X has no impact on RGDP in short-run while positive and significant impact in long-run. At first, this finding sounds confusing for short-run because exports bring money to a country, thus increase economic growth. Certainly exports are the

main source of foreign exchange reserves for developing countries like Pakistan. International trade allows countries to profit from their domestically produced goods by selling them to other countries. As a result, trading with other countries or participating in trade agreements boosts economic growth (Abdullahi et al., 2013). Exports not only indicates that there is a high level of output from productive sectors but also a sign that greater number of people are employed in order to achieve the production goal inside the Pakistan. Exports leads to trade surplus which contributes to economic growth. Neoclassical economists like Marshall, 1959 also claimed in the 19th century that international trade is one of the primary causes of nation economic growth. But its effect can not be seen in short-run because transmission of effects of X on RGDP takes time. Its not easy for a developing country like Pakistan, which are facing different challenges like energy shortage to increase the export and enjoy its growth prospect immediately. In addition, Pakistan exports are mainly raw material, rather than semi finished or finished goods and the price of raw material in world market is very low, so that's why export X shows no impact on RGDP in short-run. INV has positive and significant impact on RGDP in short and long-run is rational. In general, higher saving rate leads to more investment and investment leads to economic growth. A large amount of investment in the form of capital formation in an economy push to increase in production, employment and income level of the people, which in return definitely boost the RGDP. when the economy grows, the economy contributes to a growth in the household disposable income (Attanaio, O. P., Picci, L., and Scorcu, A.E. (2000). The findings of this study are in line with Solow-Swan growth model

which attempts to explain long-run economic growth by looking at capital accumulation(investment), labour or population growth and increase in productivity, commonly referred to technological progress. FEA has positive and significant impact in both short-run and long-run on RGDP of Pakistan which is logical. Developing country like Pakistan, usually facing the problems like lack of capital formation inside the country due to the huge gape between savings and investments, so transfer of capital resources from developed countries to under developed countries, can normally be expected to be as growth-enhancer in both short-run and long-run. Foreign Economic Assistance (foreign aid) develops the economy by providing infrastructures and other developmental projects (Kolawole, 2013).

CONCLUSSION

This study was conducted to exam the impact of X, INV and FEA on RGDP of Pakistan in short-run and long-run, in order to present a model to improve the RGDP of Pakistan. Based on the results of the data analysis and discussion presented in the previous chapter, it is concluded that export (X) has statistically insignificant or no impact on RGDP in short-run while has positive and statistically significant impact in long-run, at 10% level of significance. This means that in long-run, the increase of USD 1 in X, leads to the rise of RGDP by USD 4.85 while other things held constant. Investment (INV) has positive and statistically significant impact on RGDP in both short and long-run at 10% level of significance. This means that in short-run, an increase of USD 1 in INV, leads to the rise in RGDP by USD 3.50 and in long-run, an increase of USD 1 in INV, leads to the rise in RGDP by USD 3.22 while other

things held constant. Foreign Economic Assistance (FEA) has statistically insignificant or no impact on RGDP in short-run while has positive and statistically significant impact on RGDP in long-run, at 10% level of significance. This means that in long-run, an increase of USD 1 in FEA leads to the rise in RGDP by USD 4.88 while other things held constant. The R-squared value for long-run is 0.978775 which indicates that 0.97 or 97% of the variance of the dependent variable being studied is explained by the variance of the independent variables, while the remain 3% is explained by the variance of variables outside the model. So, the model is best fits and RGDP is explained by X, INV and FEA.

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