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The Current Account Balance of Pakistan 1972-2005: A Cointegration Analysis

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Abstract: This study aims to find the factors that influence the current account balance of Pakistan. In this study, we utilized cointegration and error correction modeling techniques in estimating the long run behavioral relationship between Pakistan's current account balance and different economic variables. The empirical results advocate that there exists a significant long term relationship between the current account balance and the balance of trade, domestic saving, total consumption and workers remittances during the observed period 1972 to 2005.

Key words: Cointegration, error correction, current account balance, balance of trade, domestic saving, total consumption and workers remittances

INTRODUCTION

Large and persistent trade and current account deficit are some of the most burning topics among politicians and economists all over the world during the last few decades. Current account has a significant role in the economic development of a country. It shows a country's economic performances that can help domestic as well as foreign investors in investment plans. Current account deficit can be caused by such factors as excessive domestic demand, a lack of domestic saving, overvalued exchange rates, government policies regarding imports and exports, domestic production capacity and capability and so on. A country suffering from current account deficit means that it is spending more than it is earning. Its consumers, firms and government are collectively spending more than what they are earning from domestic production and earnings on net foreign investments. A temporary current account deficit is not a serious problem for an economy and can be easily adjusted. However, a large and chronic current account deficit is more harmful and a bigger problem for an economy and needs the attention of policy makers and requires appropriate policies adjustments. Large and persistent current account deficit can affect an economy from many sides. When a country is running a current account deficit, it uses more than what it produces and imports more goods than its exports to other countries. When domestic demand is high and domestic producers are unable to fulfill all of this excessive demand, the demand for imported goods and services increases, ultimately leading

to an increase in the trade and current account deficit. In another way this deficit leads to the depreciation of the local currency which means an appreciation in the foreign exchange rate. This devaluation of the local currency has a positive impact on exports as the local products are available at a lower price in foreign currency and in foreign markets. It also negatively impacts imports as it makes the import of goods and assets more expensive because the local currency is weak. If a country doesn't have enough production capacity to satisfy the increased foreign demand of local products, this will affect the balance of imports and exports. Ultimately there is further increase in the trade and current account deficit (Gulzar and Hui, 2006).

Recently, many researchers devoted a lot of effort to investigate the effects of current account deficit on an economy and the factors that influence it. Sachs *et al.* (1981) estimate whether oil prices or investment demand was the main causes of the variation in current account balances across countries in the 1970s. Their findings advocate that investment had a greater relative influence on the current account than oil prices. Using cross-section and panel data over the period 1973- 93 for 21 industrial countries, Debelle and Faruquee's (1996) findings imply that, the real exchange rate, the business cycle and the terms of trade have a short-run effect on the current account, while the stage of development and demographics have longer-run effects. Chinn and Prasad (2003) find that current account balances are positively correlated with government budget balances and initial stocks of net foreign assets. Among developing

countries, measures of financial deepening are positively associated with current account balances while indicators of openness to international trade are negatively correlated with current account balances. Bannaga (2004) conducted a time series analysis for the data on the Sudanese economy for the period 1960-2000 by employing the error correction model technique. He explained that the composition of Sudan's current account showed that a persistently large trade deficit was a clear indicator of a problem with Sudan's export structural competitiveness. Moreover, gross domestic savings and excessive private consumption continued to deteriorate. He also found that adjustment reform did improve the current account position or even to bring it back to its level of before the reforms introduction. Javed and Ashfaq (2004) explained that the main causes of current account deficit of Pakistan are: exports concentrated on low value added products, few commodities and agriculture products, imports based on capital goods and limited to few countries, a declining trend of terms of trade and high dependency on the amount of workers' remittances. Stockman (2005) explain that the rise in the US current account deficit has been caused mainly by an increase in saving in the rest of the world, particularly nations that had financial crises within the last decade or so, oil-exporting countries that have seen oil revenue rise significantly over the last decade and (for various reasons) Germany, while at the same time the US has continued to offer the best investments that foreign savers and foreign central banks can find. This large increase in foreign saving has reduced interest rates in the US and around the world. Partly for this reason, the US savings rate has declined. Chinn and Ito (2005) with the help of regression techniques, use the current account data of 117 countries over 33 years they find that current account balances are positively correlated with government budget balances and initial stocks of net foreign assets. One key finding they obtain in this extended sample is that the government budget balance has a positive and statistically significant impact upon the current account for industrialized countries. They also find that the developing country current account balances are under predicted. In order to find out the accurate relationship between current account balance and different economic factors Gulzar and Hui (2006) used a regression model based on data from Pakistan for thirty financial years, 1972-2001. Their findings advocate that the percentage change in the volume of imports, foreign direct investments and total consumption are positively correlated while on the other hand, exports, workers remittance, growth in agriculture and manufacturing are negatively correlated with the current account deficit. To

the best of our knowledge, there are no other studies founded that focus on the current account balance of Pakistan by applying cointegration techniques.

The main objective of this study is to find out what are the key economic factors that influenced the current account balance of Pakistan and caused a deficit. In order to confirm and quantify the true long run relationship we utilized the latest econometric techniques and developed Vector Autoregressive (VAR) and Vector Error Correction (VEC) models. Our estimated models show that the relationship between the balance of trade, domestic saving and workers remittances are positively correlated, while, on the other hand total consumption is negatively correlated with current account balance of Pakistan. Moreover, the relationships of all variables are significant.

CURRENT ACCOUNT 1972-2005

Pakistan is among those countries who have been suffering from a current account deficit and this problem is chronic from many decades. In 1958, Pakistan was trapped in a vicious cycle of deficit in the balance of payments. Its performance in the foreign trade sector was reasonably good during the three Financial Years (FY) 1953, 54 and 56. Its average exports were 161 million US\$ more than its imports and it had a surplus balance of trade up to FY1956-57. After 15 years of trade deficit in FY1973 Pakistan had a favorable trade balance, yet that was the last financial year in which this occurred in the country. Since that time, Pakistan has been facing a chronic problem of trade and current account deficits. Its current account deficit was at a record level of US\$ -4,575 million in 1996 claiming -4.96% of GDP and at its highest surplus in FY 2003 with US\$ 3,165 million that is 4.77% of GDP. On the other hand, the situation was entirely different in FY 2005 where the current account had a favorable position, while the trade deficit was at US\$ -6,185 million -8.2% of GDP, the highest ever in the trade history of Pakistan (MPS, 2006). The trade deficit is the major factor in Pakistan's current account deficit.

In order to find out the graphical relationship between the current account, trade balances and workers remittances we plotted a graph (Fig. 1) showing the combined movements of all factors. We can easily deduce that when there is an increase in the trade deficit then there is also an increase in the current account deficit. This situation changed after 30 financial years in 2001. The current account balance moved in surplus despite a worsening of the balance of trade in goods. The main reason for the improvement in the figure is a very strong transfer of money by overseas Pakistani. Figure 1 clearly

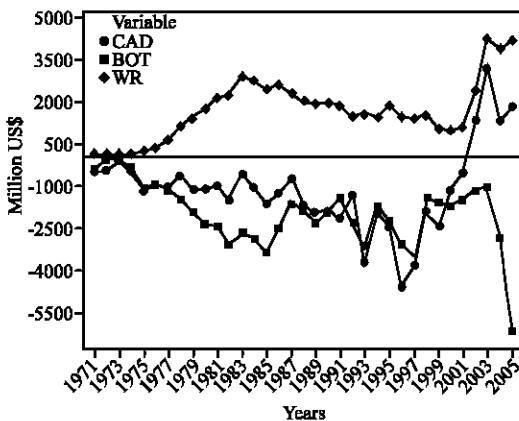


Fig. 1: Current account, trade and workers' remittance balances 1971- 2005

reveals the surplus in the current account caused by the increase in workers remittance after the event of September 11, 2001.

Pakistan's current account balance is highly dependent on the volume of workers remittances. A large and persistent amount of workers remittances always supports huge payments but these remittances can not be sustained over a long period of time. Pakistan's current account balance used to suffer from a trend of fluctuating workers remittances since the year of its independence. The position of workers remittances changed after segregation of East Pakistan (Bangladesh) from West Pakistan (Pakistan at present) in 1971. There was a sudden rise in the workers remittances at the end the seventies and the start of the eighties. But this increase did not support a conversion of the current account deficit into a surplus. The event of September 11, FY2001 change the situation and there is a tremendous increase in the workers remittances especially from the United Kingdom, USA and some European countries. This caused a surplus in the current account balance for the first time since FY 1951.

DATA COLLECTION AND SELECTION OF VARIABLES

The annual data of all the variables for the period FY 1972 to 2005 are obtained from the Handbook of Statistics on Pakistan Economy 2005, various issues and publications of the State Bank of Pakistan. The reason for the selection of this period is that in the FY 1971-72 Pakistan was separated from former East Pakistan (Bangladesh). Present study is based on the data related to West Pakistan (Islamic Republic of Pakistan) only. We

have selected four variables for our study and the details are given below.

Balance of trade: Trade balance consists of exports and imports which both play a dominant role in the determination of the current account balance. Increase in the volume of exports supports the current account balance. However, this increase must be greater than the volume of imports. If the volume of exports increases at the same proportion or less than imports then this increase in the exports will not support the current account balance and will cause a trade deficit. While on the other hand, imports of a country depend upon domestic demand and production capacity. If the local producers are unable to produce enough goods to satisfy the domestic demand then increased imports are required to fill this gap. A high volume of imports as well as concentration of imports on capital products are a cause for a current account deficit.

Workers' remittances: Workers' remittances play an important role in the economic development of a country. Large and persistent amounts of workers' remittances not only support huge payment balances but also help aid domestic investment. Increase in the volume of workers' remittances helps in reducing the current account deficit.

Total consumption: A high rate of consumption means low gross domestic savings and therefore, less money is available for domestic investment and that causes the inflow of foreign investment. Therefore, increases in the consumption level mean increases in the current account deficit and low consumption aids in reducing current account deficit.

Domestic saving: The current account deficit is equivalent to the difference between gross domestic saving and gross domestic investment of a country. So, if a country is running a current account deficit its gross domestic investment must be greater than its gross saving by an account equal to the current account deficit. High domestic savings means low consumption habits, less demand for goods and lower availability of funds for investments. All investments in factories, housing and capital spending are financed by domestic savings. Domestic savings includes saving by the government, corporations and by individuals (households). An increase in domestic savings means an increase in the investment and production level that ultimately helps in increasing export volume and a decline in the current account deficit.

MODEL DESCRIPTION

After selection of the above variables we can describe the current account function of Pakistan in the following way:

$$Cab = f(Bot, Ds, Tc, Wr) \tag{1}$$

Where Cab is the current account balance, f represents the function of and Bot, Ds, Tc and Wr represent, respectively, balance of trade, domestic saving, total consumption and workers remittances. After specifying the current account function in liner form with an addition of error term μ_t ,

We can write Eq. 1 in following way:

$$Cab_t = \beta_0 + \beta_1 Bot_t + \beta_2 Ds_t - \beta_3 Tc_t + \beta_4 Wr_t + \mu_t \tag{2}$$

In Eq. 2 the coefficient on the balance of trade has a positive sign which indicates that an increase in the trade balance will cause an increase in the current account balance and a decrease will reduce the current account balance. Moreover, domestic savings and workers remittances both have also positive signs. This means that an increase in the balances of domestic savings and workers' remittances will increase the current account balance and a decrease will cause a negative affect. Furthermore, total consumption is the only factor that has a negative sign, indicating that an increase in the consumption level will decrease the current account balance and a decrease in consumption will enhance the current account balance.

Engle and Granger (EG) in 1987 described cointegration technique as, if each element of vector of time series X_t is stationary only after differencing, but a liner combination $\alpha'X_t$ need not be differenced, the time series X_t having been defined to be co-integrated of order (1, 1) with co-integrating vector α . Interpreting $\alpha'X_t$ as long run equilibrium, co-integration implies that equilibrium holds except for a stationary, finite variance disturbance even though the series themselves are non-stationary and have infinite variance. The main objective of the cointegration test is to find out whether a group of non-stationary series is cointegrated or not. In order to examine the time series properties of our data, we used the cointegration technique. Two types of tests are generally used for cointegration, one by EG and other is proposed by Johansen. The later test gives us most consistent and accurate results of cointegration and considered superior from EG test. Since it corrects for some of the shortcomings with the EG test, mainly being a two-step test in which error in the first step are carried over the

second step (Abu-Qarn and Abubader, 2001). In this study we used the Johansen Cointegration (1991). Consider a VAR of order p

$$z_t = \eta_1 z_{t-1} + \dots + \eta_p z_{t-p} + Bx_t + \epsilon_t \tag{3}$$

Where z_t is a k-vector of non stationary I (I) variables, x_t is a d vector of deterministic variable and ϵ_t is a vectors of innovations. We can rewrite this VAR as:

$$\Delta z_t = \Pi z_{t-1} + \sum_{i=1}^{k-1} \Gamma_i \Delta z_{t-i} + B y_t + \epsilon_t \tag{4}$$

Where

$$\Pi = \sum_{i=1}^k \eta_i - I, \quad \Gamma_i = - \sum_{j=i+1}^p \eta_j \tag{5}$$

Where Π has reduced rank $r < k$, then there exist $k \times r$ matrices α and β each with rank r such that $\Pi = \alpha\beta'$ and $\beta'y_t$. r is the number of cointegrating relations and each column of β is the cointegrating vector (Johansen, 1991).

Equation 5 is called Vector Error Correction Model (VECM). It is a restricted VAR designed applicable only for a time series that is nonstationary and known to be cointegrated. The VEC has a cointegration relation built into the specification so that it restricts the long-run behavior of the endogenous variables to coverage to their cointegration relationships while allowing for short-run adjustment dynamic. The cointegration term is known as the error correction term since the deviation from long-run equilibrium is corrected gradually through a series of partial short-run adjustments (E-views 5).

EMPIRICAL RESULTS AND FINDINGS

It is necessary to determine the stationary properties of time series before we carry on the Johansen Maximum Likelihood cointegration analysis.

UNIT ROOT TEST

Here, we perform unit root tests for stationarity on the levels and the first differences of all five variables. We have used the Augmented Dickey-Fuller (ADF) unit-root tests. Because of the ADF unit-root tests give us the most reliable results. There are three types of different conditions in the ADF test for every time series. First, random process includes intercept (c) and trend (t). Second, random process includes intercept (c) but no trend (0). Third, random process includes no intercept (0) and trend (t). In this research we apply a model with

Table 1: Test of the unit root hypothesis

Variables	Types of test (c, t, n)	ADF test statistic	1% critical value	5% critical value	DW statistic	Probability
Cab	c 0 1	-1.114512	-3.646342	-2.954021	2.004146	0.6982
Δ Cab	c 0 1	-4.900321*	-3.653730	-2.957110	1.907239	0.0004
Bot	c 0 1	-2.001369	-3.646342	-2.954021	1.552623	0.2849
Δ Bot	c 0 1	-3.780535*	-3.653730	-2.957110	1.661571	0.0073
Ds	c 0 1	1.921994	-3.646342	-2.954021	1.798702	0.9997
Δ Ds	c 0 1	-4.990069*	-3.653730	-2.957110	1.917839	0.0003
Tc	c 0 1	2.027461	-3.646342	-2.954021	1.686733	0.9998
Δ Tc	c 0 1	-4.479325*	-3.653730	-2.957110	1.799597	0.0012
Wr	c 0 1	-1.252384	-3.646342	-2.954021	2.016558	0.6395
Δ Wr	c 0 1	-3.408018**	-3.653730	-2.957110	1.982213	0.0181

* Rejected null hypothesis at 1% significant level, ** rejected null hypothesis at 5% significant level. Term c, t and n represent intercept, trend and lags respectively. Probability means MacKinnon (1996) one-sided p-values. Δ indicate the first differential of variable

intercept and without trend. As we have taken annual data sets, we will use the lag (n = 1). Therefore, we chose (c, t, n) = (c, 0, 1) in the ADF test (Wang *et al.*, 2006). The results of the test indicates that all the variables; current account balance, balance of trade, domestic saving, total consumption and worker’s remittances have a unit root in their levels and are stationary in their first differences. Table 1 demonstrates the results. The test rejected the null hypothesis that there is a unit root in the first difference of every variable at a 1% significant level (for variables Cab, Bot, Ds and Tc) and at a 5% significant level (for variables Wr). The Durbin-Watson statistics also support the value of each variable as significant.

JOHANSEN COINTEGRATION TEST

We found that all the series of five variables (Cab, Bot, Ds, Tc and Wr) are integrated of order one I (1) preprocesses. Our next step is to determine whether any combinations of the variables have a cointegrated relationship. Before applying the cointegration tests, we first specify the relevant order of lags (p) of the VAR model. For this purpose we use: Final Prediction Error (FPE), Akaike Information Criterion (AIC), Schwarz Information Criterion (SC) and Hannan-Quinn Information Criterion (HQ). Table 2 shows the results of the optimal lag selection. According to the results of these tests, we selected the lag 2 in the VAR model.

The results obtained from the Johansen Cointegration method are presented in Table 3. The first column illustrates Ho, with r ≤ 0, r ≤ 1, r ≤ 2, r ≤ 3 and r ≤ 4 denotes at most none, at most 1, at most 2, at most 3 and at most 4 cointegration relationships. The second column points out the Eigenvalue. The third column gives us trace and Max-Eigen statistics and the remaining two columns represent 5 and 1% critical values.

The Trace test indicates 3 cointegrating equations at the 5% level and 2 cointegrating equations at the 1% level. Max-Eigenvalue test indicates 3 cointegrating

Table 2: Statistic for VAR lag order selection

Lag	FPE	AIC	SC	HQ
0	1.72E+32	88.41455	88.64130	88.49084
1	2.32E+29	81.78684	83.14730*	82.24460
2	1.06E+29*	80.88713*	83.38131	81.72635*

FPE: Final Prediction Error, AIC: Akaike Information Criterion, SC: Schwarz Information Criterion, HQ: Hannan-Quinn Information Criterion. * Indicates lag order selected by the criterion

Table 3: VAR cointegration test statistic

Hypothesized No. of CE(s)	Eigenvalue	Trace statistic	5% critical value	1% critical value
r = 0 **	0.750600	104.929900	68.52	76.07
r ≤ 1 **	0.565373	59.102850	47.21	54.46
r ≤ 2 *	0.487353	31.605050	29.68	35.65
r ≤ 3	0.240496	9.555543	15.41	20.04
r ≤ 4	0.014368	0.477572	3.76	6.65

Hypothesized No. of CE(s)	Eigenvalue	Max-eigen statistic	5% critical value	1% critical value
r = 0 **	0.750600	45.827010	33.46	38.77
r ≤ 1 *	0.565373	27.497800	27.07	32.24
r ≤ 2 *	0.487353	22.049510	20.97	25.52
r ≤ 3	0.240496	9.077971	14.07	18.63
r ≤ 4	0.014368	0.477572	3.76	6.65

*(**) denotes rejection of the hypothesis at the 5% (1%) level

equations at the 5% level and 1 cointegrating equations at the 1% level. These statistics indicate to us that three null hypotheses are rejected. This means that there are three cointegrating equations r ≤ 3 among the four variables at a 5% significant level. Therefore, our annual data from 1972 to 2005 appears to support our intention that in Pakistan there exist a long-run relationship between the current account balance, balance of trade, domestic saving, total consumption and workers remittances.

Estimation of long-run cointegrating vector is given in the Table 4.

If we put the data of Table 4 in Eq. 2 we obtain the following Cointegration Eq. 6, showing the long-run relationship of variables:

$$\text{Cab} = 1.368905\text{Bot} + 0.951601\text{Ds} - 0.306918\text{Tc} + 2.866005\text{Wr} + 2371.643 \quad (6)$$

Table 4: Estimation of cointegration and adjustment coefficient

CAB(-1)	BOT(-1)	DS(-1)	TC(-1)	WR(-1)	C
Normalized cointegrating coefficients					
1.000000	-1.368905	-0.951601	0.306918	-2.866005	-2371.643
	(0.33478)	(0.22983)	(0.06146)	(0.22890)	
	[-4.08902]	[-4.14040]	[4.99376]	[-12.5210]	
Adjustment Coefficients					
D(CAB)	D(BOT)	D(DS)	D(TC)	D(WR)	
0.698780	0.463036	0.281884	-1.032938	0.133500	
(0.11050)	(0.10637)	(0.17434)	(0.48733)	(0.06803)	
[6.32374]	[4.35314]	[1.61685]	[-2.11957]	[1.96233]	
Standard errors in parentheses and t-statistics in brackets					

Equation 6 describes that a 1% increase in the balance of trade causes a 1.37% increase in the current account balance. Moreover, the results predict that a 1% increase in the domestic saving will bring 0.95% increase in the current account balance. Furthermore, for each 1% increase in the workers remittances causes 2.866% increase in the current account balance. However, the increase in the total consumption has no obvious effect on the current account balance. In the estimated equation, the coefficient of Tc is negative which means a 1% change (increase) in the Tc will decrease the current account balance by 0.31%.

In our model we find the positive correlation of the current account balance with the balance of trade. The basic problem of the trade deficit is related with an excess of imports over exports. The exports of Pakistan are based on low value added products and raw materials. If we have a look at the last 15 financial years, country exports have been based on only a few products. An average 81% of the exports are based on 5 items: cotton 60.19%, leather 7.15%, rice 5.58%, synthetic textiles 5.29% and sports goods 2.86%. Cotton and rice alone contributed about 66% of the total exports (Economic Survey, 2003-04). Such a high degree of dependency on agriculture-related products is an element of uncertainty in export earnings. Agriculture in Pakistan is influenced by weather conditions and water resources. The decline in agricultural production due to weather conditions not only affected exports, but also had bad effects on textile manufacturing (Gulzar and Hui, 2007a). On the other hand, the situation is totally different for imports which are based on eight commodities, namely, machinery, petroleum and petroleum products, chemicals, iron and steel, transport equipment, edible oil, fertilizer and tea. These eight categories of imports accounted for an average 75.35% of total imports during the last fifteen financial years. More than 1/2 of the total import bill paid for the first three categories (machinery 19.66%, petroleum and petroleum products 21.60% and chemicals 15.47%) (Economic Survey, 2003-04). The trade deficit grew every

year due to rising oil import prices. Oil prices are tremendously increasing in international markets. All the efforts made to reduce the trade deficit were made futile by the rising oil prices in the world markets (Gulzar and Hui, 2007b).

In our cointegration analysis domestic saving has a positive correlation with the current account balance of Pakistan. It is basic economic thought that slower growth economies have higher saving habits compared to faster growth economies because of constant income and uncertain future increases in income. But the situation in Pakistan is different. The economy has lower savings with a slower growth rate. Its average gross domestic saving percentage of GDP from 1997 to 2004 stood at 14.1% as compared with 47.5% for Singapore, 44.6% for Malaysia, 39.19% for China, 32.4% for Hong Kong and 23.7% for India (Asian Development outlook 2003). Pakistan has lower savings compared to all developing countries. A small share of this savings inflicts a wide penalty for Pakistan. Lower savings induces investors to borrow money from the outside and partially filled the investment gap and so in this way they exceed investment over savings. The country also has to pay interest for the borrowed money and that ultimately causes a current account deficit.

Increased in the per capita income is one of the main reasons for increases in the spending power of the consumers. Pakistan per capita income grew by an average rate of 13.9% per annum during the last four years. It has given fuel to consumer spending and it is the main reason for the sharp increase in consumer spending during last three years. In particular, the middle classes are becoming an increasingly dominant force. Real private consumption expenditure has grown at an average rate of 10.9% per annum during last three years (11.5% in 2003-04, 13.1% in 2004-05 and 8.1% in 2005-06) (Economic Survey, 2005-06). But producers are still unable to meet all of the high aggregate domestic demand and so the demand for imported goods and services has increased in order to fulfill the excessive demand. It is also observed that Pakistani people have a high propensity to buy imported goods instead of domestic. There may be a lack of international competitiveness of domestic Pakistani industries or a view of international good as a status symbol. High consumption not only affects the imports balance but also distresses the domestic saving rate; ultimately, it leads to an increase in the trade and current account deficit.

In our model, we find the strongest relationship between workers remittances and the current account balance. Worker remittance is the second largest source of foreign exchange earnings of Pakistan after exports. It

has played an imperative role in reducing the current account balance and huge payments balances. The IMF explained the importance of workers remittances in the World Economic Outlook, April 2005 as remittances can help improve the country's development prospects, maintain macroeconomic stability, mitigate the impact of adverse shock and reduce poverty. Remittances allow families to maintain or increase expenditure on basic consumption, housing, education and small business formation. The current position of Pakistan's current account balance is worse than the last few years. It had three consecutive years of current account surplus (FY 2002 to 2004), but after that it went back to its previous track in 2005-06 and stood at US\$ -4.7 billion deficit in the first nine months (July-March). In economic survey 2005-06 Pakistan ministry of finance expressed that, huge payments against higher oil import bills on the back of high global crude oil prices, hefty rises in non-oil imports fueled by strong demand and a decline in the growth of net transfers are all responsible for the widening of the current account deficit. Furthermore, higher freight charges by international shipping lines as a result of the sharp increase in global trade and higher fuel costs and a growth in personal travel due to the rising level of income of middle and high income groups, have also contributed to the widening of the current account gap.

Although Pakistan's current account position is undoubtedly difficult, it is clearly not so bad that it can't be controlled. Much can be done by the government, private sector and individuals to overcome this problem. The basic problem with current account is the balance of trade- that is related to exports and imports balances. Pakistan should try to exports manufactured goods instead of raw materials and agricultural products. The government of Pakistan should provide facilities for the establishment of domestic industries. This step would not only satisfy domestic demand but will also help in reducing imports and enhancing exports volumes. Imports should be based on raw materials and low value added products that can help in local manufacturing and reduce the trade deficit. A healthy interest rate can help in escalating the saving habits and domestic investment. By taking some essential steps on the international level Pakistan can improve its current economic situation. It can make good relationships with neighboring India and can set the stage for bilateral talks for the trade and services sectors. The reconstruction of Afghanistan is also offering a good business opportunity. The opening of Gwadar port can make Pakistan a regional transport hub, enabling it to easily serve central Asia and China. Pakistan should sign joint ventures with other

neighboring countries regarding the establishment of labor intensive manufacturing industries and exchange for the latest technology. Transportation, shipping, tourism, textile manufacturing, machinery, plants, garments and construction sectors are all areas where Pakistan has a competitive advantage. Cheap labour and the availability of raw materials will help in signing joint ventures.

CONCLUSIONS

In this research, we utilize the latest econometric time series techniques and an attempt is made to identify the long term relationship between the current account balance of Pakistan and different economic factors during the period 1972 to 2005. Our estimated vector autoregressive and vector error correction models reveal that the relationship between the balance of trade, domestic saving and workers remittances are positively correlated, while, on the other hand total consumption is negatively correlated with the current account balance of Pakistan. The results, however, do not place more importance on total consumption with the current account balance of Pakistan. Moreover, the relationships of all variables are significant. Present study concludes that the basic problem with the current account is the balance of trade- that related to exports and imports balances. If the balance of trade will turn into a surplus this problem will surely be resolve. On the other hand, current account balance is strongly supported by workers' remittances and it should be sustained in long run. Savings habits should be increased in order to meet the domestic investment requirement and to support the current account balance.

This study also provides a clue for further research work, as most of the trade deficit is due to oil imports and high oil prices in the world market. One can use the latest econometric techniques, applied to annual data and can find the essential relationship between oil prices and the trade deficit. Moreover, some other economic factors such as budget deficit, foreign direct investment and manufacturing growth rate can be included for an analysis of the current account deficit. It will definitely give more reliable results.

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