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# The Relationship among International Trade, Financial Development and Economic Growth: The Case of Pakistan

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**Abstract**

This study is conducted to investigate the relationship among international trade, financial development and economic growth in Pakistan. The ADF and PP tests are used to check the order of integration of the variables and Johansen co-integration methodology is employed to investigate the long run relationship among these variables. The direction of causality between variable is tested by Granger causality test. It is found that all of the variables are non-stationary and the analysis confirm for a long run relationship among international trade, financial development and economic growth. The results indicate that international trade and financial development spur economic growth in Pakistan.

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*Keywords:* International trade; Financial development; Economic growth; Co-integration.

## 1. Introduction

GDP growth is one of the most important criteria to evaluate the performance of an economy. To identify the main drivers of economic growth and the potential sources of growth a large number of studies have been conducted. These studies indicate different drivers of growth including foreign direct investment, domestic

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investment, financial development and export. This study aims to analyze the relationship among international trade, financial development and economic growth by employing time series analysis.

The relationship between economic growth and export which is an important component of international trade has taken the attention of many scholars. Most of the studies resulted that export has positive impact on economic growth (Ullah et al., 2009). Although export led growth empirically has been investigated intensively, the direction of causality is still under debate. In a developing economy, some manufacturing firms may undergo substantial changes as a result of learning, technical modernizations, experiences and technology allocation via foreign direct investment (FDI). Under these circumstances; even if there is no government policy that attempt to achieve development by encouraging free trade policies, it is possible to enhance output growth. If domestic demand does not increase as much as the output growth in these flourishing industries; manufacturers can export the surplus. Hence, export growth can be promoted by economic growth in a country. However, if domestic demand growth is higher than industrial production growth, this may lead to a decrease in export. As a result, the domestic demand induces an increase in domestic output which is accompanied by a decrease in export; so, productivity in growth can deteriorate the export performance to the country (Lee and Huang, 2002).

We have a vast literature regarding the relationship between financial development and economic growth. There is consensus in the literature that financial development assists economic growth through various channels, including export expansion (Shahbaz and Rahman, 2014). A well-functioning financial sector of a country can also have positive impact on export in addition to its influence on output growth (Hur and Riyanto, 2006; Shahbaz, 2009). So to have higher export shares in world trade it's important to have a well-developed financial system.

Yuan et al. (2014) state that the impact of international trade and financial development on growth has become an important research subject. According to the traditional theoretical framework of the factor endowment, enterprises can enhance their ability to overcome liquidity shortages with the help of financial development by encouraging exports of products with high dependence on external financing and advancing the scale and structure of trade production. Rajan and Zingales (1998) explore a relative beneficiary theory of financial development and claim that financial development helps enterprises to avoid moral hazard and adverse selection problems and to enhance export growth promoted by the external financing. Financial development represents certain degree of comparative advantage for those industries which have higher dependence on external financing. Such industries are likely to have greater growth rates and higher shares of exports and obtain more trade benefits in countries those have higher level of financial development.

Although there is a vast literature that investigates the relationship among GDP growth, export and financial development; literature on Pakistan is limited. This study aims to investigate the existence of the long run relationship between international trade, financial development and economic growth and, direction of causal relationship between these variables for Pakistan.

The article proceeds as follows: Section three defines data and methodology of the study. Section four provides results and discussions and the paper concludes with section five.

## 2. Literature Review

Financial sector development is considered as on one of the most important sources of comparative advantage. Beck (2003), Svaleryd and Vlachos (2005) investigate the relationship between financial development and trade from the economies of scale perspective. They find that trade has been affected by the financial sector. A more developed financial sector channel more saving to the private sector, facilitate enterprises with the use of external financing so that firms can overcome liquidity constraints. Zhang et al. (2012) conduct a study on relationship between financial development and economic growth in China and the results show that most indicators of financial development have positive relation with economic growth. Al-Yousif (2002) finds bidirectional causality between financial development and GDP growth for thirty developing countries for the period of 1970-1999. Emmanual and Lartey (2010) study the effect of financial development on economic growth for a panel of 74 counties and find that financial development has a positive effect on economic growth which doesn't vary with the level of financial development.

Jenkins and Katircioglu (2008) investigate the long run relationship between financial development, international trade and economic growth for Cyprus. Results shows that international trade, financial development and economic

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