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Original Research Article

External Trade and Economic Growth Relationship Under Trouble: Time Series Evidence from Palestine

Gaber H. Abugamea

Al-Azhar University-Gaza, Gaza Strip, Palestine, Economics Dep.

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The economies and trade of Palestinian territories (PTs) in the Gaza Strip and West Bank have undergone numerous shocks and instabilities over the past four decades. Palestinian External trade experienced numerous difficulties and in particular Israel imposing for restriction on Palestinian trade with the neighboring countries and the rest of the world as a whole. This study uses the cointegration and Granger causality tests to examine both the long run and short run relationships between economic growth, exports and imports of Palestine for the time period 1968-2012. The results, based on Vector Error Correction model show the existence of the long run relationship between imports and economic growth given exports stationary. Moreover, both exports and imports are considered main determinants of economic growth in Palestine. Granger causality test shows no causality among exports and imports and economic growth. Mainly, causality tests confirm VECM results that import cause changes on economic growth in the long run but not in the short run. These results guide towards a number of policies aiming a successful and sustained economic growth.

Keywords Economic growth, Exports, Imports, Cointegration and Granger causality tests Palestine.

INTRODUCTION

It is widely accepted that trade contribute to both economic growth and development in different countries. Palestine is considered as a one of developing countries which experienced the impact of occupation along a number of decades and its foreign trade affected negatively from the procedures and policies of the Israeli occupation. Balance trade in the Palestinian territories in the West Bank and the Gaza Strip characterized by a continuous deficit lasted for decades since 1967 year. Yet, the experience of these years shows a steady growth in merchandise imports and in total imports fueled by opportunities permits the access of goods from abroad to West Bank and Gaza Strip. This import pattern coexisted with a stagnant behavior of exports due to weak productive capabilities and excessive restrictions on trade and exports in most time periods. The main objective of this paper is to explore the dynamics of the relationship between external trade components imports and exports and economic growth in Palestine using the annual data for the period 1968 to 2012. The paper organized as follows: Section 2 contains a selective review of the literature. Section 3 describes the data and methodology. Section 4 presents the empirical results and section 5 concludes the discussion.

LITERATURE REVIEW

The literature on economic development and trade has emphasized the export to accelerate growth of the economy. It is argued that exports are helpful in economic growth process through different channel e.g. economies of scale, efficient allocation of economic resources, enhanced capacity utilization, improved productivity of factors of production and diffusion of innovation and technological knowledge. The role played by exports to promote the growth of an economy or the export-led growth hypothesis, occupies the main stage in the development literature where export promotion and increased trade openness have gradually replaced import substitution along with economic growth(Bhagwati, 1978; Balassa, 1978; Krueger, 1978; Feder, 1982; Krueger, 1990) . The trade openness shifts the trade policies from being highly import substituting as well as government controlled to become deregulated and more liberalized.

However, many studies have focused attention on the importance of imports on economic growth. Recent endogenous growth models have emphasized the role of imports as an important channel for foreign technology and knowledge to flow into the domestic economy (Grossman and Helpman, 1991; Lee, 1995; Mazumdar, 2001). New technologies could be embodied in imports of intermediate

*Corresponding Author: Gaber H. Abugamea. Al-Azhar University-Gaza, Gaza Strip, Palestine, Economics Dep.
Email: gabernew@yahoo.com

goods such as machines and equipments and labour productivity could increase over time as workers acquire the knowledge from the new embodied technology (Thangavelu and Rajaguru, 2004) . Moreover, It is acknowledged that imports play a central role in the countries whose manufacturing base is built on export oriented industries (Esfahani, 1991; Serletis, 1992; Riezman et.al, 1996; liu et.al., 1997).Given this background numerous studies discussed and still examine the impact of exports or exports and / or imports on economic growth. Vohra (2001) denoted the relationship between the exports and economic growth in countries of India, Pakistan, Philippines, Malaysia, and Thailand for the period 1973 to 1993. The empirical results showed that when a country has achieved some level of economic development then the exports have a positive and significant impact on economic growth.

Subasat (2002) suggested that the more export-oriented countries like middle income countries grow faster than the relatively less export-oriented countries and showed that export promotion does not have any significant impact on economic growth for low and high income countries. Amavilah (2003) determined the role of exports in economic growth for Namibia by the period 1968 to 1992. Results explained the general importance of exports, but finds no a distinctive sign of the growth acceleration due to exports. Lin (2003) indicated that 10 per cent increase in exports caused 1 per cent increase in GDP in the 1990s in China on the basis of proposed estimation method, when both direct and indirect contributions are considered.

Shirazi and Menap (2004) studied the short-run and long-run relationship among real exports, real imports and economic growth in Pakistan for the period 1960 to 2003. They showed a long-run relationship among imports, exports and economic growth and found unidirectional causality from exports to output, but without any significant causality between imports and exports. Thurayia (2004) studied the relationship between exports and economic growth experienced in Saudi Arabia and Sudan. It found that the growth rate un total exports in Saudi Arabia had an active role in achieving economic growth while it had a weak influence in Sudan. The results of cointegration and error correction analysis showed a positive effect of exports on GDP in the short and long run, which confirms the validity of the hypothesis of export-led growth in these countries. Mah (2005) studied the long run causality between exports and economic growth for China using error correction modeling. This study found that export expansion is insufficient to explain the patterns of real economic growth.

Tang (2006) denoted that there is no long run relationship between exports real gross domestic product and imports. The study further shows no short and long run causality between export expansion and economic growth in China based on Granger causality test while economic growth does granger cause imports in the short run. Jordan (2007) analyzed the causality between exports and GDP of Namibia for the period 1970 to 2005. It tested the export led growth hypothesis through granger causality and cointegration models. The results concluded that exports granger cause GDP and GDP per capita and suggested that the export led growth strategy via various incentives has a positive effect on growth. Ugur (2008) analyzed the relationship between imports and economic growth in Turkey. Empirical results derived from impulse response function and variance decomposition analysis showed that while there is a bidirectional relationship between GDP and investment goods import and raw material import there is a unidirectional relationship between GDP and consumption goods import and other goods import.

Pazim (2009) tested the validity of export led growth hypothesis for Indonesia, Malaysia and Philippine by using panel data analysis. It is concluded that there exists no significant relationship between the size on national income and amounts of exports for these countries based on one way random effect model. The panel unit root test shows that both GDP and exports seem not stationary, while the panel cointegration test indicates that there is no cointegration relationship between the exports and economic growth in these countries. Ullah et al (2009) reinvestigated the export led growth hypothesis using time series econometric techniques over the period 1970 to 2008 for Pakistan. The results reveal that export expansion leads to economic growth. Elbeydi et al (2010) investigated the relationship between exports and economic growth in Libya for the period 1980 to 2007. They concluded that there exists a long run bidirectional causality between exports and income growth and thus the export promotion policy contribute to the economic growth of Libya.

Mishara (2011) reinvestigated the dynamics of the relationship between exports and economic growth for India over the period 1970 to 2009 by applying time series econometric techniques of cointegration and vector error correction estimation. It provides the evidence of the existence of long run equilibrium relation between them and confirms the rejection of export led growth hypothesis by the Granger causality test based on vector error correction model estimation. Khan et al (2012) uses the Granger causality and cointegration to examine the long run relation between economic growth, exports and imports of Pakistan for the time period from 1972 to 2009. The results based on error correction model show the existence of long run relation among exports, imports and economic growth. Also, it was found that both exports and imports are considered an essential part for economic growth in Pakistan, and thus a successful and sustained economic growth requires growth of both exports and imports.

Relating to the Palestinian case there are a number of studies which denoted to the effect of growth in economic activity on external trade or discussed the relationship between trade, economic trade and development. Abugamea (2005) evaluated the performance of Palestinian foreign trade over the period 1968 to 2000 by following a specific export modeling connect between trade ratio and the variables economic activity represented by gross domestic product, competitiveness (real exchange rate) factor and total fixed investment. It used panel analysis methodology throughout fixed effect procedure to highlight heterogeneity between Palestinian trade and a number of neighboring countries of Egypt, Jordan and Syria. Distinctively, it was found that Palestinian trade ratio impacted negatively by the growth of economic activity, a situation reflects decreasing in exports compared with imports under the impacts of compulsory economic integration with Israel.

Abugamea (2008) used seemingly unrelated regression equations estimation procedures for import-export trade modeling vis-à-vis an ordinary least square one to forecast the behavior of trade. The study denoted that main feature of the imbalanced customs union between the Palestinian areas in the West Bank and Gaza Strip was that while the Palestinian demand (economic activity) had a positive significant impact on imports from and export to Israel, both the Israeli and the rest of the world demand growth (GDPs) had an insignificant impact on the Palestinian exports. UNCTAD (2012) investigated relationship between trade and growth by using descriptive analysis for the period 1980 t0 2005. It denoted to the absence of a clear systematic relationship between trade

and growth, whereas GDP per capita has been declining over this period, with annual growth of about 2.5 per cent on average , the trade ratio (sum of exports and imports/GDP) exhibits no particular trend and showed very unstable behavior. This performance reflects the effects of various distortions faced the Palestinian trade under occupation policies. Bsharat (2014) investigated the effect of both domestic demand represented by growth in the Palestinian GDP and growth in the Israeli GDP and the number of closure days on Palestinian export performance for the period 2000 to 2013. The study used vector error correction modeling methodology. Mainly, it concluded the existence of cointegration in the long run among these variables. Moreover, in the short run it was found that export affected positively with growth in Israeli GDP and adversely with number of closure days.

In view of this background this study uses cointegration and Granger causality econometric techniques to examine the long run relation between economic growth, exports and imports of Palestine taking time series data for the period 1968-2012.

DATA AND METHODOLOGY

The objective of this paper is to explore the dynamics of the relationship between external trade components imports and exports and economic growth in Palestine using the annual data for the period 1968 to 2012. In this study, the variables are total imports (IMP), total exports (EXP) in the Palestinian territories and economic growth (GDP). Both total imports and exports include merchandise and services trade expressed in US dollars. The real gross domestic product (GDP) is used as the proxy for economic growth in Palestine. Data for the sample period are obtained from both Palestinian Central Bureau Statistics (PCBS) and Palestine Monetary Authority (PMA) publications. All the variables are taken in their natural logarithms to be leveled.

In this study we employed time series econometric techniques, mainly rely on cointegration and error correction modeling.

Estimation Procedure Consists of Three Steps

Firt, unit root test, second, cointegration test, third, Granger Causality test based on the error correction model estimation (VECM). Unit Root Tests: The purpose of unit root test is to check whether the data is stationary or not. The data is said to be stationary if its mean, variance and covariance remain constant over time. Consider the following AR(1) model:

$$Yt = \phi\, Yt\text{-}1 + \square t \qquad (1)$$

The stationary condition is $\phi<1$.
Case 1: $\phi<1$ the data is stationary.
Case 2: $\phi>1$ the series exploded
Case 3: $\phi=1$ shows unit root and non-stationary
this paper we use both the Augmented Dickey-Fuller (ADF) and the Phillips-Perron (PP) tests to examine the data set for stationarity. These are used to eliminate the problem of autocorrelation. The determination of lag length is based on Akaike Information Criterion (AIC) and Schwartz Bayesian Criterion (SBC). Three possible forms of these tests areas shown:

$$Y\Delta_t = \gamma Y_{t-1} + \sum_{i=1}^{p} \beta Y\Delta_{t-1} + e_t \qquad (2)$$

$$Y\Delta_t = \alpha_o + \gamma Y_{t-1} + \sum_{i=1}^{p} \beta Y\Delta_{t-1} + e_t \qquad (3)$$

$$Y\Delta_t = \alpha_o + \gamma Y_{t-1} + \alpha_1 t + \sum_{i=1}^{p} \beta_i \Delta_{t-1} + e_t \qquad (4)$$

Where 0α is constant, α1 , βi , γi are slope coefficients, t is a linear time trend and et is the error term. The null hypothesis can be expressed as: H0: γ = 0, on the other hand, alternative hypothesis is H1: γ <0. Cointegration Tests: The Johansen cointegration test is employed to check the long-run relation between the concerned variables. The variables which have the same order of integration could be checked for cointegration. In this study we will see only two variables are examined for the cointegration. The Johansen cointegration test shows the long run properties of the variables where the test is based on the maximum likelihood estimation of the K-dimentional Vector Autoregression (VAR) having order p. Both the trace eigenvalue statistic and the maximum eigenvalue statistic are used.

Granger Causality Test Based on VECM: The order of Vector Autoregression (VAR) of order p in the error-correction model is determined by minimizing the Akaike Information Criterion (AIC) and Schwartz Bayesian Criterion (SBC). The Granger causality test is used to check the causality between the concerned variables. The granger causality test is based on the following Vector Error Correction Models (VECMs):

$$\Delta LGDP_t = \delta_1 + \sum_{i=1}^{n-1} a_{1i}\ \Delta LGDP_{t-i} + \sum_{i=0}^{j-1} \gamma_{1i} \Delta\ IMP_{t-i}\ \Delta LGDP_{t-i} + \phi_1 ECT_{t-1} + \omega_{1t} \qquad (5)$$

$$\Delta LIMP_t = \delta_2 + \sum_{i=0}^{n-1} a_{2i}\ \Delta\ LGDP_{t-i} + \sum_{i=1}^{j-1} \gamma_{2i}\ \Delta LIMP_{t-1} + \phi_2 ECT_{t-1} + \omega_{2t} \qquad (6)$$

Where, Δ = Difference operator, ECTt-1 = One period lagged value of the error correction term. The significant error correction term is interpreted as the long-run causal effect.

Table (1): Unit Root Tests

Variable	Augmented Dicky Fuller Test		Phillips-Peron Test		Conclusion
	Intercept	Intercept and Trend	Intercept	Intercept and Trend	
LGDP	-1.2048 (0.6641)	-3.6156 (0.0394)	-1.3371 (0.6039)	-3.5900 (0.0423)	I(1)
Δ LGDP	-8.2664* (0.000)	-8.2281* (0.000)	-8.4354* (0.000)	-8.4313* (0.000)	
LIMP	-2.1845 (0.2147)	-3.2320 (0.0915)	-2.2259 (0.2003)	2.9236 (0.1653)	I(1)
Δ LIMP	-5.3177* (0.0001)	-5.5364* (0.0002)	-4.9656* (0.0002)	-5.31004* (0.0004)	
LEXP	-2.0719** (0.2566)	-2.9568 (0.1554)	-2.0667** (0.2586)	-2.5346 (0.3109)	I(0)

Figures indicate t-statistic and in parenthesis are p values. *and ** show significant at 1% and 5% levels respectively.

Table (2): Johansen Co-integration Tests

Null Hypothesis	Alternative Hypothesis	Trace Statistics	5% Critical Value with p values**	Max-Eigen Value	5% Critical with p Value**
r=0	r=1	41.65885	15.49471 (0.000)	40.59997	14.26460 (0.000)
r=1	r=2	0.024325	1.058887 (0.3035)	1.058887	3.841466 (0.3035)

Denotes rejection of the hypothesis at the 5% level. Figures in parentheses are Mackinon-Haug-Michelis (1999) p-values

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Table (3): Results of Granger Causality test based on VEM

Vector Error Correction Estimates Sample: 1968-2012 Sample (adjusted): 1971 2012		
	Dependent variables	
Regressors	Δ LIMP	Δ LGDP
Δ LIMP(-1)	0.4272 (0.1518) (3.0756)*	0.284470 (0.1254) (2.2693)**
Δ LIMP(-2)	0.0473 (0.1240) (0.3815)	0.0084 (0.1119) (0.0749)
Δ LGDP(-1)	-0.5797 **(0.2594)** **(-2.**2348) **	-0.7546 (0.2341) (-3.2237) *
Δ LGDP(-2)	-0.5121 (0.2386) (-2.1469) **	-0.1536 (0.2153) (-0.7134)
Constant	-2.5512 (0.4556) (-5.5996) *	-0.8657 (0.4112) (-2.1054) **
LEXP	0.4586 (0.0786) (5.8344) *	0.1623 (0.0709) (2.28890) **
$ECT_{(t-1)}$	-1.047380 (0.1518) (-6.8995) *	-0.3379 (0.1369) (-2.4663) *
R^2	0.6869	0.2909
Adj. R^2	0.63333	0.1694
F-statistic	12.7989	2.3940
S.E. equation	0.1128	0.1018

*and ** denote significant at 5% and 10% levels, respectively.

Table(4): Results of Granger Causality Test

Null Hypothesis	*F-statistic	Probability	Decision
DLIMP does not Granger Cause DLGDP	2.2830	0.1161	Accept
DLGDP does not Granger Cause DLIMP	2.0244	0.1465	Accept

Number of lags =2

EMPIRICAL ANALYSIS

The stationary properties of the variables; GDP, IMP,EXP are examined by using the Augmented Dickey-Fuller (ADF) and Phillips-Perron (FP) tests, before employing tests for cointegration and Granger causality. These tests were applied to determine the order of integration on level as well on first differences. Stationarity of all the variables are tested at intercept and then at intercept and trend. The results of these tests are shown in Table (1). The results conclude that real GDP and imports are stationary at first difference but exports at level. Thus, GDP and IMP are integrated of the same order i.e I(1) and EXP is I(0).

Since the variables GDP and IMP are integrated of the same order i.e I(1), the hypothesis of cointegration are examined by the Johansen cointegration test. The results of this test are given in Table (2). Both the Trace statistics and the Max-Eigen Value are greater than the critical value at 5% significance level under the null hypothesis of no cointegration vector (r=0) and lesser than the ones under the null hypothesis of one cointegrating vector. Hence both of the test statistics indicate one cointegrating vector, and there is the long run equilibrium relation between economic growth and imports given exports stationary. Having cointegration between economic growth and imports, the final step is to check the causality between the two variables by using the Vector Error Correction Model (VECM).

The estimation of VECM requires selection of an appropriate lag length. The number of lags in the model is determined according to the Schwarz Information Criterion (SIC). The lag length that minimized the SIC is 2. Then, an error correction model with the computed t-values of the regression coefficients is estimated and the results are reported in Table (3). The estimated coefficient of error correction term ECTt-1 in the IMP equation is statistically significant and has a negative sign, which confirms the long run equilibrium relation between the independent and dependent variables at 5 per cent level of significance. Also, its relative value (-1.047) in this case shows the rate of convergence to the equilibrium state per year. Clearly, the speed of adjustment of any disequilibrium in imports towards a long run equilibrium is about 105 per cent of the disequilibrium in imports is corrected each year. This situation denotes to unbridled rush of imports in light of the Palestinian case which experienced cases of uncontrolled openness after strict closures with the rest of the world.

Once again, the estimated coefficients of error correction term ECTt-1 in GDP equation is statistically significant and has a negative sign , which also confirm the long run equilibrium relation between independent and dependent variables at 5 per cent level of significance. Also, its relative value (-0.337) in this case shows the rate of convergence to the equilibrium state per year. Precisely, the speed of adjustment of any disequilibrium in economic growth towards a long run equilibrium is that about 33.7 per cent of the disequilibrium in economic growth is corrected each year.

Also, in both economic growth and imports equations the coefficients of the first difference of IMP and GDP lagged one and/or two periods indicate to some extent of the existence of short-run causality from imports to GDP in economic growth equation and from GDP to imports in case of imports equation. Yet, F-statistic value (12.7) in Table (3) from imports equation confirms the significant effect of GDP with other variables on imports but not for the effect of imports with other variables on GDP equation.

In order to confirm the results of short-run causality between the Δ LIMP and Δ LGDP based on VECM estimates, a standard Granger Causality test is also performed based on the F-values. The results in Table (4) indicate that IMP does not Granger cause GDP and GDP does not cause IMP at 5 per cent level of significance. This result supports the ones obtained from VECM that there is no short-run causality at 5 per cent level of significance. Thus based on these causality tests, changes in imports cause changes in economic growth (GDP) in the long run but not in the short run. Overall, these results conclude the existence of long run relation between imports and economic growth and a weak nexus between them in the short run.

CONCLUSIONS AND RECOMMENDATION

This study uses the cointegration and the Granger causality tests to examine the long run relation as well as to check the specific direction of the causality among economic growth, exports and imports in Palestine. The econometric results based on vector error correction models (VECM) confirm the existence of a long run relation between imports and economic growth and show that both exports and imports are the main determinants of economic growth in the Palestinian case. Causality tests confirm VECM results that imports cause changes in economic growth in the long run but not in the short run. These results highlight the dynamic role of imports in Palestine which coexisted with a stationary pattern of exports in most periods of time in past four decades. These finding guide to a number of policy implications, in particular, the government should encourage the imports of essential raw materials for value addition which will expand the production capacity and accelerate economic growth and should pay a considerable attention to export by adopting such policies that support the local productive sectors, a situation expected to lead exports towards a dynamic status.

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