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Effects of Banking Sector Credits in Estimating Import Demand of Pakistan: Evidence from FMOLS and DOLS Approach

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ABSTRACT

The role of financial development in trade policies is one of the most concerning issues in developing countries. In this context, the current research highlights the crucial role of banking sector credits in determining Pakistan's import demand. The analysis is based on annual data from 1985 to 2020. This study formulated three import demand models that incorporate sector-wise bank credits in the industrial, agricultural, and service sectors, used as a proxy for financial development. The Dynamic Ordinary Least Squares (DOLS) estimation results indicate that, in the long run, credit to the agriculture sector has a negative and significant effect on import demand. In contrast, industrial sector credit has a positive and significant effect on import demand. This finding suggests that the higher credit demand of the industrial sector intensifies the burden on Pakistan’s balance of payments. Moreover, the coefficient of consumption expenditure is the primary driver of import demand in all models. The coefficient of relative price has shown a theoretically negative sign and a significant effect on import demand. The Fully Modified Ordinary Least Squares (FMOLS) test reconfirmed the (DOLS) findings. However, the CUSUM test also confirms the stability of the model parameters. It is recommended that the import substitution policy be adopted to curb the industrial sector's demand for imported items, as well as that the central bank increase the share of credit allocated to the agricultural sector to promote its growth. This could also contribute to reducing Pakistan's balance of payment deficit.

Keywords: import demand, consumption, financial development, central bank

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