KASBIT Business Journal, *15*(2), 28-38, June 2022

AN Effect of trade shortfall, External obligation on exchange rate, a case study on Pakistan

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Abstract

Current economic conditions in developing countries are very problematic, particularly devaluations in a currency that leads to an increase in the Exchange rate(ER), Moreover, change in exchange rate with less export and more imports developing countries have faced the problem of trade deficit(TD) at same time deficit balance of payment(DBOP), due to deficit balance of payment developing country has unable to pay external debts(EDs) which leads to again increase in ER this cycle generates several problems So, researchers 1st core objective is to ascertain the impact of TD on EDs and 2nd core objective is to ascertain the impact of EDs on ER. Several literature and theories highlighted the relationship between these IVs and DV. Researchers used preceding 15 years' secondary data related to Pakistan. 15 years of data consist of three different governments and different policymakers. For analysis, scholars used correlation and OLS techniques with the help of Ms excel and E-views to check whether the result are the same or not with other researchers. The finding of this study shows that all three alternative hypotheses are accepted and have a significant impact.

Keywords: *Developing countries (DC), External Debt(ED), Exchange Rate(ER), Trade Deficit (TD),*

Overview of Study

Present fiscal conditions in emerging countries are very challenging mainly devaluations in money/currency of a specific country that leads to a rise in the Exchange rate(ER) of other countries, Additionally, change in exchange rate with fewer exports and more imports developing countries have faced the problem of trade deficit(TD) at same time deficit balance of payment(DBOP), due to deficit balance of payment developing country has incapable to pay external debts(EDs) which leads to again increase in ER, this cycle produces numerous problem also supported by Litecoin, Peercoin, Auroracoin, Dogecoin, and Ripple, etc. Due to easy and free access, another research (Caves, Frankel, & Jones, 1990). higher Exports have a positive and significant contribution toward economic growth and they increase the foreign reserves of the country as suggested by other researchers (Soofi, 2016). but in our developing economy, there is the main problem and low rate of export and a high rate of imports which leads to an outflow of foreign reserves from the economy. According to Jiranyakul & Brahmasrene, 2019 if a country controls its currency through an internal mechanism in short-run but it is not beneficial in long run. International sanctions put pressure on the trade of a country which leads to a problem in payment of external debts if the country pays their ED due to payment out-flow increases and additionally increase ER in the economy.

Countries do trade with other country countries export their domestic products and import other countries' products which are not made in that country. Net export is in positive value it's called trade surplus but if the net export value is negative it’s known as a trade deficit. (Caves, Frankel, & Jones, 1990). The different countries produced different goods and services. They sell these goods and services on the domestic market as well as on the international market, if any country export or import any product it’s come under international trade. (Caves, Frankel, & Jones, 1990). The trade deficit has a major impact on economies, the country which experience a high trade deficit face balance of payment issues which force them to go for a foreign loan. (Tiwari, 2015). According to the International Monitory Fund, the balance of payment is a major issue for small economies, the balance of payment is the major reason for increases in the debt of these economies.

Known as an agricultural economy, since 1950 Pakistan has never experienced sustainable GDP growth, the economy of Pakistan experienced much to slow down from time to time, but one of the major issues for policy maker in Pakistan is the increase in foreign debt. Many are rising due to the current account deficit (Awan & Asghar, 2011) Pakistan's current account deficit and fiscal debt is major issue that every government policymaker face, they have tried hard to overcome these issues but policy maker fails to control these external debts. Some policy maker thing that trade deficit is the main key problem. (Awan & Asghar, 2011). According to the state bank of Pakistan That exchange rate depreciation is also accrued due to these two major problems, recently world bank issued a report on Pakistan's economy which indicate Pakistan which facing a massive economic slowdown due to an increase in foreign debt and current account deficit. Further World bank says the only way for Pakistan to overcome this economic slowdown is to increase export to control the trade deficit.

Research Gap

Several types of research are on a similar topic but with different variables like import and export respectively this study has distinctive work to perform the with a total balance of trade shortfall on external obligations and exchange rate suggested by other researchers in their studies also (Chaudhary, Hashmi, & Khan, 2016; Blavasciunaite, Garsviene, & Matuzeviciute, 2020)

Problem Statement

According to Muktar, Zakaira, & Ahmed,(2007) exchange rate instability considered a a major economic problem, but policy maker is divided on the reason behind the Exchange rate volatility, some policy maker believes that fiscal annual budget deficit plays a key role in exchange rate depreciations Other economists believe that and policy maker believe the reason of this is not Physical budget deficit, its current account deficit which leads to exchange rate devaluation.

Exchange rate devaluation, trade deficits, and external debt are Major problems for developing economies. After every period these problems create major economic slow days in third world countries. This slows down their GDP growth after every short period and brings them under the shadow of world financial institutions' and economic packages, these problems not only create economic challenges for developing also a constant threat to their sovereignty. On the other hand Devaluation causes an increase in the inflation rate in their domestic market. Which causes an increase in poverty; do any of these variables have multiplier effects on the economy?

In the case of Pakistan, it's going like an ending cycle, in last from the last 50 years Pakistan rupee constantly devalued from time to time, and Pakistan's external debt also raise with the passage of time as well Pakistan's Current account deficit also increased. These balance of payment issues after every short period kept Pakistan standing in the front of an international financial institutions, which impose hard conditionality's on the economy before passing the economic packages. One of their ever first demands is depreciating the exchange rate, which always causes an increase in inflation, Economic activity slowing down, increase in the poverty ratio. But the key problem remains the same instead hard decision to reform the economy. Pakistan's net exports are negative the gap is increased in the last two decades and according to state bank statistics in this period our exchange rate also depreciates by about 300%, and our external debate also increased by about 300%. So the question is, what are the main reason behind exchange rate depreciation and increase in external debt? According to Polak & Chang, (1950-1951) study for IMF, the depreciation in the exchange rate will cause an increase in net export. Which increases the inflows in the economy and decreases the outflows. That's why with every economic package exchange rate devaluation is the IMF's first and key demand. But according to the ministry of finance report of 2017-2016 prove that incase of Pakistan the result are completely remain opposite to IMF that theory. Instead of massive devaluation Pakistan's current account deficit nor end, or decrease.

Objective

The objective of conducting this study is for, Authors, want to identify the key reason that causes devaluation and increase of the external debt. The authors want to identify how much current account debt has an impact on the exchange rate, and what the relationship between the net trade deficit and external debt. What is the indirect relationship between net current account deficit, external debt, and exchange rate? The authors want to identify which variable could control the entire circle, How countries could take control over external debt and make their exchange rate stable.

Scope

This study is conducted on a single economy of a developing country in Asia and just analyzing three variable. Current account deficit, external debt, and exchange rate. So this study only could predict one dimension of the entire picture. The result of this study only could be applicable to developing economies, and the economies which face balance of payment issues.

Literature Review

Dependency on external debt could lead a county toward a debt trap. Increasing foreign debt could not only affect the country's economic growth but also causes inflation as the debt should be returned with an interest more debt to be taken to return previous debt and interest which affect countries' foreign reserve and causes exchange rate depreciations. (Aderemi, Fagbola, & Ebere, 2020). The trade deficit is a very serious issue for many countries, it directly affects the country's foreign reserves, and exchange rate. if the net trade is the negative country will not face a balance of payment issue and if its continues then it leads the country to an external debt trap. (Fuard, Rinosha, & Shifaniya, 2021). For the last decade trade deficit remains a major problem for developing countries, which put them in alarming situations of losing foreign reserves which forces them to talk about external debt to maintain their reserves that cycle turn bigger and bigger which impacts the economic growth of the country. (Dawood & Baidoo, 2021).

Due to its complex history Economy of Pakistan consider a the complicated economy. Pakistan's economy experienced 3 major changes, from 1947 onward Pakistan adopt Capitalism as an economic structure, then in 1973 Pakistan started transforming its economy from a capitalist economy to a social economy, again 1980 onward Pakistan chose maxed economic structure as an economic model. These Major shifts in the entire economic system damage the economic institutes of Pakistan. (Khan S. R., 1999). Pakistan Adopt different strategies to control the outflow from the economy, different Governments impose banned on different lines of products to import, and Pakistan increase the tariff on different goods, to promote domestic industry and control import. (KEMAL & SIDDIQUI, 2002). Instead of this approach, Pakistan's net export deficit increased with the passage of time. Which lead the country toward the balance of payment issue (Awan & Asghar, 2011), Pakistan's exchange rate also depreciated, Foreign debt burden increased dramatically over time (Muktar, Zakaira, & Ahmed, 2007). Pakistan's trade deficit and external debt data show the country is in a very serious debt trap, data shows that about 70% tax revenues of Pakistan spend on debt services, and Pakistan's external debt is increasing due to large trade deficit and getting large with the passage of time. (Awan & Qasim, 2020).

Exchange Rate

Krugman & Obstfeld, (2008) Defined As exchange rate as followed; the real exchange rate is defined as the national price level between two economies; the Exchange rate is any country's currency value of purchasing any unit. When you compare that value of the currency with any other country's currency value that calls country's exchange rate. Chapter no 13.

Counties have different frameworks to regulate and set the exchange rate policies, but most scholars believe, that one factor should not be only considered when police makers made the regulatory mechanism of the exchange rate. There are two key factors that must be considered same time equally internal trade, Inflation, people purchasing power, and External trade so their prices should remain competitive in the international market. If policy maker keeps the focus on one variable and set the exchange rate it will not be beneficiary for long-term economic growth. (Behera & Yadav, 2019)

External Debt

External Debts are loans or economic packages any countries borrow from another country or any international fund agency. (IMF, 2002). External borrowing keeps countries' economic policies dependent. An increases in external debt makes countries dependable for the long term on external funding. Once external debt increase from a certain level, then it's hard for an economy to easily skip out. Because then a country borrows again to pay previous installments. This situation leads the economy toward also unending fiscal deficit situation. (Nehru & Kraay, 2006). Further Robinson, (2012) in their Book why nations fail explains: that increase in external debt will cause an economic slowdown in the long-term the amount which you have to spend on Public social services and development will go to pay the external repayment, in long term its increase the outflow, which causes also increase in current account deficit. Impact of External debt on Exchange rate!

An increase in external debt creates a disequilibrium situation between inflow and outflow. Countries borrow when they face economic instability or balance of payment issues. An increase in external debt indirectly affect the exchange rate. (Dornbusch, 1984). When a country goes for a bailout package for International Monitory Fund or any other international funding agency their first demand is to depreciate the exchange rate to increase the export. To overcome the balance of payment issue. Weak economies never keep their exchange rate in equilibrium. (Cespesdes, Chang, & Andres, 2000)

H1 External debts have a significant impact on the exchange rate.

Trade deficit

If a country's Imports bill exceeds the Export total bill it's considered a a trade deficit. Country negative net export is also known as a trade deficit (Behera & Yadav, 2019). There are multiple reasons for trade deficit, poor economic activities, Law industrial structure, and low productivity. Some country doesn't spend on innovation and industrial development due to which they export nonvalue-added product at cheap price and import value-added products at high price which lead them to a trade deficit. (Behera & Yadav, 2019). Some countries spend high on defense technology which is totally based on import and cause a net trade deficit. (Gold, 1990) Impact of the Trade deficit on External debt

An increase in trade debt creates a balance of payment issue for the country. That balance of payment issue push country to borrow more to maintain their foreign reserves. (Awan & Asghar, 2011). As the trade deficit increase government make sure safe the country from bankruptcy, she borrows more to pay the excess import bill. (Khan S. R., 1999).
H2a Trade deficit has a significant impact on External debt.

Conceptual Research Model

Trade Deficit → **External Debt** → **Exchange Rate**

Research Methodology

Data Collection Methodology

For conducting this study, we have to used the secondary data technique. The secondary data have been collected from the State Bank of Pakistan website and the World Bank website; help also has been taken from other economic sites. researchers have taken 15-year historical data to analyze the change in the different variables. Beginning from 2005 as the first year and has been taken as the base year. The other year's data have been divided with a base year and multiplied by 1 one to have the change in shape percentage in all variables, which is useful to analyze the change in different variables throughout the period. This researcher use MS excel, and E views software for analysis of secondary data supported by another researcher as well (Awan & Mukhtar, 2019). Researchers analyze the data with correlations among variables and develop two stages model/equation the first researcher work on the impact of trade deficit as IV on External debt as DV and the second External debt is used as IV and Exchange rate as DV due to these reason researchers develop and analyze two equations that given below

Y=c+bx1+e
Y1=c+bx2+e
Explanation of 1st equation
Y= External debt
C = constant
Bx1 = beta of (trade deficit) independent variable
e = error term
Explanation of 2nd equation
Y1= Exchange Rate
C = constant
Bx2 = beta of (External debt) independent variable
e = error term

Discussions of results

Researchers begin with correlation among variables and given below table shows the values of correlation among Trade deficit with External debts and Exchange Rate. First TD and ED have a correlation value is 0.5056 which means an above 50% relationship between TD and ED if one variable has a change it will have an impact on the other variable by around 50%. 2nd TD and ER has a correlation value is 0.6035 which means an above 60% relationship between TD and ER if one variable has a change it will have an impact on the other variable around 50%. 3rd ED and ER have a correlation value is 0.5056 which means an above 55% relationship between ED and ER if one variable has changed it will have an impact on another variable by around 55%.

Table no. 1

	Trade deficit	External debt	Exchange Rate
Trade deficit	1.000000	0.505688	0.603538
External debt	0.505688	1.000000	0.556667
Exchange Rate	0.603538	0.556667	1.000000

Figure no.1

Dependent Variable: SERIES06
Method: Least Squares
Date: 01/08/22 Time: 12:30
Sample (adjusted): 2 16
Included observations: 15 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.148653	0.132401	1.122753	0.2819
SERIES07	0.815560	0.068848	11.84577	0.0000

R-squared	0.915211	Mean dependent var	1.649545
Adjusted R-squared	0.908689	S.D. dependent var	0.492462
S.E. of regression	0.148811	Akaike info criterion	-0.848718
Sum squared resid	0.287880	Schwarz criterion	-0.754312
Log likelihood	8.365388	Hannan-Quinn criter.	-0.849724
F-statistic	140.3223	Durbin-Watson stat	1.847626
Prob(F-statistic)	0.000000		

In this study, authors have tested the impact of the Trade deficit on External debt, and external debt with two different software above mention results was produced by e-views to make sure that the results are similar or not so, above given results with two-stage old and series05 (TD) on series06 (ED) showing the result P-value is not greater than 0.05, T-value is 2.8 and it is not less than 2 and R-squares value is 0.376 it means IV explain DV more than 37% So it shows TD has an impact on ED suggested by another researcher as well (Hair, Risher, Sarstedt, & Ringle, 2019; Khan & Ahmed, 2015)

Figure no.2

Dependent Variable: SERIES05
Method: Least Squares
Date: 01/08/22 Time: 12:26
Sample (adjusted): 2 16
Included observations: 15 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.244809	0.562597	0.435140	0.6706
SERIES06	0.918018	0.327704	2.801366	0.0150

R-squared	0.376429	Mean dependent var	1.759121
Adjusted R-squared	0.328462	S.D. dependent var	0.736856
S.E. of regression	0.603835	Akaike info criterion	1.952533
Sum squared resid	4.740011	Schwarz criterion	2.046940
Log likelihood	12.64400	Hannan-Quinn criter.	1.951527
F-statistic	7.847653	Durbin-Watson stat	1.903462
Prob(F-statistic)	0.014990		

In this study, authors have tested the impact of the Trade deficit on External debt, and external debt with two different software above mention results was produced by e-views to make sure that the results are similar or not so, above given results with two-stage old and series06 (ED) on series07 (ER) showing the result P-value is not greater than 0.05, T-value is 11.8 and it is not less than 2 and R-squares value is 0.915 it means IV explain DV more than 91% So it shows ED has an impact on ER recommended by another researcher as well (Hair, Risher, Sarstedt, & Ringle, 2019; Khan & Ahmed, 2015)

Discussion on results

In this study, authors have checked the impact of the Trade deficit on External debt, and the external debt impact on the Exchange rate. A previous researcher said that the trade deficit has an indirect impact on the exchange rate, authors have checked in trade deficit impact on external debt which has been seen in the table that trade deficit has a significance impact on external debt. Trade deficit creates the balance of payment issues in the economy which forces countries to borrow to keep foreign reserves stable, which causes an increase in external debts (Kannan & Bhupal, 2009). As it has mentioned in the above article the trade deficit has a direct impact on external debt another study by (Awan & Mukhtar, 2019) has shown that Pakistan's external debt has increased along with the trade deficit. Our second hypothesis was external debt impact on the exchange rate in our study this has been seen that external debt has a direct impact on the exchange rate. In a study conducted by (Tiwari, 2015). In the context of Asia that external debt has direct effect on exchange rates in developing economies. (Bunescu, 2014) The study says that increase in external debts causes devaluation in the exchange rate. (Kumar, Bhutto, Mangrio, & Kalhoro, 2019) The study says that in Pakistan external debts have a direct impact on the exchange rate, study further elaborated that external debt and exchange rate relation in Pakistan are positively correlated with each other, and the exchange rate has a negative relation with GDP growth.

Policy Maker implication

The study found that Trade deficit is the key variable that cause an increase in external debt, and Exchange rate, although our study was limited tell this 3 variable but was found during the literature review analysis that exchange rate depreciation also leads to an increase in inflation and unemployment. Policy makers should give key attention to the production of competitive goods and import substitute products. That trade deficit could be controlled. This is a variable that has a multiplier impact on the economy. Trade deficit control should be the first agenda of any policy maker that way countries could sustain and make their exchange rate stable to control another economic variable which dependent on the exchange rate.

Conclusion

Entire study concludes that the trade deficit is like cancer for the economy which is the father of all economic evils. Trade deficit causes an increase in external trade debt, which makes the economic policy dependable on different world financial institutions, and Powers. On the other hand its causes depreciation in the exchange rate. According to Krugman & Obstfeld(2008) that exchange rate deprecation cause an increase in the inflation rate, unemployment, and saving rate. Decrease in domestic investment which causes economic slowdown. On the other hand "Robinson, (2012)" in their book "why nation fails" writes that an external debt increase will cause the fiscal annual budget deficit. According to him, that debt servicing will increase fiscal expenditure. Which causes an increase in domestic debt, because government borrows more to fill the fiscal deficit which leads to more debt. So these all evil starts from a single variable trade deficit which affects the entire economy. In the end, researchers said that the results are similar to other researchers (Behera & Yadav, 2019).

Limitations and Future recommendations

This research has been conducting in Pakistan only three variables have been taken trade deficit, external debt, and exchange rate. The future researcher is highly recommended to include, Fiscal deficit, Remittances, Inflation, Unemployment, and Domestic investment. Saving rate, GDP growth rate, in the model to check the exchange rate impact on the Inflation, Domestic investment, saving, and the impact these on the GDP growth. And as well causes of trade deficit should be further studied to add variables like trade policy, and other variables to identify the causes of trade deficit.

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