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RESEARCH ARTICLE

Exchange Rate Dynamics and Trade Balance Adjustment: Empirical Evidence from Pakistan

Sadia Mustafa[1], Suraya Ismail[2*], Farah Roslan[3]

[1,2,3] Faculty of Business and Management, Universiti Sultan Zainal Abidin ,Terengganu, Malaysia

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***Corresponding Author:**

surayaismail@unisza.edu.my

ABSTRACT

Given Pakistan's ongoing twin deficit, policymakers must comprehend the effect of exchange rate variations on its trade balance. This is imperative for implementing effective policies and promoting sustained economic growth in Pakistan. Current study observed the nexus between exchange rate and trade balance of Pakistan from 1984 -2023. Study used the absorption, elasticity and monetary approaches as a theoretical framework and Autoregressive Distributed lag model as for empirical analysis. The estimated results show that all the variables have significantly affect trade balance and an increase in the exchange rate depreciation, GDP growth and inflation are positively associated with trade balance both in short and long run period. Fiscal deficit and broad money are negatively associated with trade balance in the short and long run analysis. One important policy implication is that economies need to fix fundamental imbalances in order to improve trade through the exchange rate and trade policies. This paper will highlight some new understandings for policy formulation regarding trade balance, exchange rate, fiscal imbalances and economic growth.

1. INTRODUCTION

Exchange rate adjustments have significantly influenced the growth of many economies since they define their competitiveness in the global market and may either stimulate or depress commerce within economies. Exchange rate depreciation will return the economy to balance and be an excellent economic development driver. Gross Domestic Product, determines economic progress in emerging and developed countries. GDP fluctuations affect the country's overall economic growth. Fluctuations in exchange rates can have a beneficial or harmful impact on a country's economic growth. Exchange rate mentions to the rate at which one local currency is exchanged for another. It's a critical macroeconomic variable in international trade. It also establishes trade balances. An open economy is critical because it influences macroeconomic factors such as foreign direct investment, inflation, remittances, capital flows, trade and gross domestic product. If a country's exchange rate rises, its domestic exports become less expensive than its trading partners; imports fall, and exports rise. In an economy, changes in the prices of exports and imports will affect the inflation rate. As a result, exchange rate impacted the price levels of commodities exchanged. Some scholars have discovered the influence of exchange rate on trade balances in developing and non-developing nations, including Pakistan. The authors in [25] found that the exchange rate positively and considerably effects Pakistan's trade balance [12].

According to [29] a negative link exists between trade balance and the exchange rate. There is a negative association between low investment levels and high interest rates. The beneficial impact of exchange rates on the long- and short-term trade balance is [17]. Exports will often see an increase in the PKR's depreciation versus the US dollar, and ultimately, the trade balance will improve. According to [23] currency rate instability has a significant detrimental impact on imports and exports. The devaluation of currency rates is a significant issue for developing nations [8].

Pakistan is a developing nation as well. The weakening of its currency has resulted in an adverse trade balance for Pakistan. For over 35 years, Pakistan's currency rate has been determined by a set method. Because of the Sterling region's affiliation, the Pakistani rupee's original connection was formed with the British Pound. For the first time, the Pakistani rupee was devalued by 30% of the pound in 1955. The dollar is acknowledged as indispensable as the United States grows in prominence worldwide. The second adjustment in Pakistan's currency exchange rate occurred in 1972 when it was Rs. 9.90 to the US dollar. This shift persisted until 1982. The IMF's recommendation led to the Pakistani government switching the exchange rate to US dollars. Under this arrangement, State Bank of Pakistan is responsible for the PKR with US exchange rate, which is set by a weighted average of PKR with other currencies in trade (State Bank of Pakistan).

Exchange range fluctuations rapidly increased from 2018 to the present, and this is a very dangerous zone for economic growth and development. Country's trade balance has suffered due to the depreciation of the Pakistani rupee. Policymakers and the government are working to improve the trade balance. They tried several successful measures to improve the trade balance but needed something to work. Pakistan's trade balance has consistently fluctuated due to several macroeconomic variables, such as changes in the currency rate, imbalances in the fiscal system, and changes in monetary dynamics. Even though these factors are known, there is still disagreement over how they affect the trade balance overall, especially in Pakistan. Inconsistent empirical findings exacerbate the complexity of these interrelationships and make it more challenging to formulate sensible economic strategies.

Government should make intensive effort to draw in more foreign private investment, especially in the oil sector, since this may significantly boost the nation's economic growth and recovery. Prioritizing and resolving urgent issues related to political and regional instability in an economy is vital. The potential for real GDP growth is hampered by the conventional agricultural goods' lack of further value-added. The protracted completion of public investment projects like roads and electrical dams is another pressing issue that might worsen the trade imbalance by impeding infrastructure development. As a result, this poses a practical issue and calls for a practical investigation in emerging nations like Pakistan. Previous empirical research on the link between exchange rate and trade balance has produced contradictory and ambiguous findings for several countries.

Moreover, most existing research focuses only on developed countries. Therefore, it is critical to overcome the knowledge gap that exists in developing countries such as Pakistan. Pakistani policymakers and commercial banks might use the results of this study to create suitable monetary policies that would ensure consistent economic development and improve the trade balance.

2. LITERATURE REVIEW

Numerous empirical studies have been conducted to determine the link between exchange rates and trade balance in developing countries. However, there needs to be more uniformity regarding their conclusions across these studies. Multiple studies have demonstrated that the exchange rate influences the trade balance. In contrast, other studies have found no association between exchange rate and trade balance. The authors did research that revealed the positive impact of exchange rate on import and export operations with trade partners such as China, the UK, and the USA [3]. Asghar [15] highlighted that there has a negative relationship between currency rate volatility and Pakistan's trade balance. A study conducted by Hina [16] shows that the depreciation of the currency in Pakistan is detrimental to its trade. Balance. According to [17] the volatility of foreign exchange rates is advantageous to Pakistan's stability in trade balance. Other authors [19] also supported this by laying emphasis on the fact that there exists an inverse relationship between exchange rate and balance of trade. It was observed not only exchange rate of Pakistan Rupees increase with the increase in the unemployment rate of Pakistan but there was a positive correlation between the two variables as well. The researcher establish the relationship with volatility of exchange rate with exports and imports [21]. According to Kilicarslan [18], there are various determinants that cause fluctuation in exchange rate of Turkey currency [6]. A study done by Gachunga [20] established that, volatility in currency rates was closely related to the number of imports and exports in Kenya. According to [22], results show that exchange rate has a long-run positive effect on balance of trade in Albania. In their

analysis, the other in [23], identified a substantial and favorable association between worldwide wealth and the exports of Pakistan. In their study, Tatliyer and Yigit identified a consistent correlation between trade activities and the volatility of currency exchange rates in Turkey [24]. The researcher in [25], argue that reducing the currency rate is crucial for boosting exports and enhancing the trade balance of Pakistan, as supported by [14]. The researcher in [27] establish the negative correlation between actual exchange rate volatility and volume of Indian exports. The author in article [26], identified positive and negative correlations between exports and economic development in China, Pakistan, and India. The author [29] found that a depreciation in the currency's value positively impacted exports [13]. Nevertheless, they also noted that fluctuations in the currency rate had an unfavorable impact on economic progress in Pakistan economy. The author in [30] found that exchange rate positively effects on trade balance in Pakistan. The researcher found negative relationship between decline in the real effective exchange rate and increase in income regarding the trade balance in Pakistan [31]. Research done [28] revealed that fluctuations in currency exchange rates negatively impacted both imports and exports in India. The research above provides valuable insights into the relationship between volatility of currency exchange rates and diminuendos of international commerce in several countries [2].

A. Conceptual/ theoretical framework

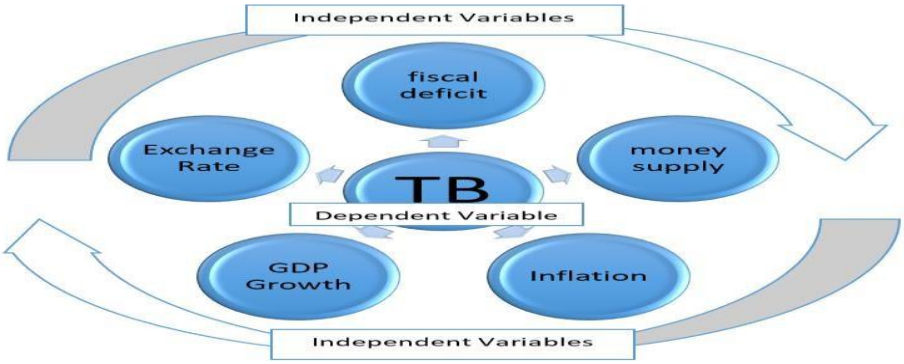

Figure 1: Conceptual framework on exchange rate and trade balance relationship

Source: authors own adjustment

Various macroeconomic variables impact the trade balance, presented in figure 2. Comprehending the impact of these factors on the trade balance is essential for policymakers to formulate effective economic policies.

- ER Depreciation → Cheaper Exports, Imports becomes expensive → It will leads to improve TB

(Marshall-Lerner Condition, J-Curve Effect)

- ↑GDP Growth→ ↑Imports (Trade Deficit) / Export-Led Growth→ Improves TB

(Absorption Approach)

- ↑ Broad Money Supply → Currency Depreciation → Exports becomes cheaper→ Improves TB
- ↑Inflation→↓competitiveness of Exports Falls → It will worsened Trade Balance

(Purchasing Power Parity (PPP) Theory)

- ↑ Fiscal Deficit → ↑ Imports (Worsened Trade Balance) → Less Competitive Exports

(Twin Deficit hypothesis)

4. DATA

Consistent outcomes require reliable and precise data. The analysis utilizes yearly data on exchange rates (ER), trade balance (TB), GDP growth (GDPg), broad money (M2), inflation (INF), and fiscal deficit (FDI) from 1984 to 2023. The data is sourced from reputable institutions such as the World

Bank (WB), State Bank of Pakistan and Pakistan Economic Survey.

B. Model specification

The entire document should be in Times New Roman or Times font. Type 3 fonts must not be used. Other font types may be used if needed for special purposes.

Recommended font sizes are shown in Table 1.

The study used Tarawalie and Kpana's (2022) base model. The original model was:

$$TB = f(MS, RER, GDP, CPI, GOV, FDI) \quad (1)$$

Modified version of base model, current model of the study is as:

$$TB = f(ER, GDPg, M2, INF, FD) \quad (2)$$

Where TB is Trade balance, ER is nominal exchange rate, FD is Fiscal Deficit, GDP is Gross Domestic Product, M2 is Broad money and INF is Inflation.

Econometric form of the model is as:

$$TB = \beta 0 + \beta 1ER + \beta 2GDPg + \beta 3M2 + \beta 4INF + \beta 3FD + \mu i \quad (3)$$

Table 1: Selected variables details

Variables	Description	Data Resources
TB	Trade Balance (% of GDP)	World Development Indicator (WDI)
ER	Exchange Rate (Dollar-rupee)	Pakistan Economic Survey(Various Issues)
GDPg	GDP Growth as a annual (%)	World Development Indicator (WDI)
M2	Broad money as a (% of GDP)	World Development Indicator (WDI)
INF	Inflation Rate (annual %)	International Financial Statistics (IFS)
FD	Fiscal Deficit (% of GDP)	International Financial Statistics (IFS)

5. ECONOMETRIC METHODOLOGY

The data analysis used three methods: Autoregressive Distributed Lag (ARDL) approach, Phillips Perron (PP) unit root test and Augmented Dickey-Fuller (ADF) test.

A. Unit root

In the ARDL bound test of cointegration, all variables under consideration are required to possess either I (1) or I (0) integration. Unit root test must be complete before proceeding to the ARDL bound test can be conducted. In this paper, the frequently used Phillips-Perron as well as Augmented Dickey-Fuller tests are used to assess the stationarity of analyzed variables. It is a technique of testing the unit root in a given time series with a view of finding out whether or not a series is stationary. As trend and intercept at level and intercept in addition to the stationarity at the first difference, this study supports the data of trend and intercept [11, 34].

B. Cointegration test

Cointegration is the approach that can be used to model time series and they can retain their long-term information. Engle and Granger presented tests and estimators to identify the presence of the long-run relationship among variables. Cointegration tests assess the linkages between variables with unpredictable variability or variables that tend to move away from equilibrium but are kept from doing so aggressively by some balancing force. It enhances the statistical and economic foundation for developing empirical error correction models with the help of both short and long-run data. Cointegration testing is crucial for determining significant long-term linkages in models [5]. In addition to the method described by Engle and Granger, several cointegration tests are available. One such test is the Autoregressive Distributed Lag cointegration technique, sometimes called bound cointegration testing [9, 32].

C. ARDL

Current study makes use of recently developed ARDL framework by Pesaran and Shin (1995, 1999), Pesaran et al. (1996) and Pesaran (1997) to ascertain the direction of causation between variables. This technique provides benefits compared to the conventional methods of Johansen and Juselius (1990). While, traditional cointegration method predicts the long-run interactions within the framework of a system of equations. RDL approach utilizes only one reduced-form equation (Pesaran & Shin, 1995). The test of the present relationship between variables in levels is significant regardless of whether the underlying regressors are pure I(0), pure I(1), or a combination of the two, as pre-testing variables is not a component of the ARDL approach [7, 33]. Given this aspect alone, together with the characteristics of the cyclical components of the data, even the existing unit root tests to ascertain the sequence of integration still require greater credibility, making cointegration technique unsuitable. Furthermore, ARDL method avoids requirements other than the standard cointegration test [6].

The general ARDL equation, which establishes a relationship between exchange rate and trade balance, is as follows:

$$\Delta(TB) = \alpha + \beta_1(TB)_{t-1} + \beta_2(ER)_{t-1} + \beta_3(GDPg)_{t-1} + \beta_4(M2)_{t-1} + \beta_5(INF)_{t-1} + \beta_6(FD)_{t-1} + \sum_{i=1}^{\alpha 1} \delta_1\Delta(TB)_{t-i} + \sum_{i=0}^{\alpha 2} \delta_2\Delta(ER)_{t-i} + \sum_{i=0}^{\alpha 3} \delta_3\Delta(GDPg)_{t-i} + \sum_{i=0}^{\alpha 4} \delta_4\Delta(m2)_{t-i} + \sum_{i=0}^{\alpha 5} \delta_5\Delta(INf)_{t-i} + \sum_{i=0}^{\alpha 7} \delta_6\Delta(FD)_{t-i} + + \varepsilon_t \quad (4)$$

In the ARDL model, parameters represent the long-run multipliers, while the symbols Δ and white noise error term represent the short-run dynamic coefficients and variables' initial differences.

The following equation can be used to determine the long-run parameters of the model on (Exchange Rate and Trade balance).

$$\Delta(TB) = \alpha + \sum_{i=1}^{\alpha 1} \eta_1(TB)_{t-i} + \sum_{i=0}^{\alpha 2} \eta_2(ER)_{t-i} + \sum_{i=0}^{\alpha 3} \eta_3(GDPg)_{t-i} + \sum_{i=0}^{\alpha 4} \eta_4(M2)_{t-i} + \sum_{i=0}^{\alpha 5} \eta_5(INF)_{t-i} + \sum_{i=0}^{\alpha 7} \eta_6(FD)_{t-i} + \varepsilon_t \quad (5)$$

The following can be used to estimate the short-term dynamics of the (Exchange Rate and Trade Balance) model.

$$\Delta(TB) = \alpha + \sum_{i=1}^{\alpha 1} \lambda_\lambda\Delta(TB)_{t-i} + \sum_{i=0}^{\alpha 2} \lambda_2\Delta(ER)_{t-i} + \sum_{i=0}^{\alpha 3} \lambda_3\Delta(GDPg)_{t-i} + \sum_{i=0}^{\alpha 4} \lambda_4\Delta(M2)_{t-i} + \sum_{i=0}^{\alpha 5} \lambda_5\Delta(INF)_{t-i} + \sum_{i=0}^{\alpha 7} \lambda_6\Delta(FD)_{t-i} + \omega ECM_{t-1} + \varepsilon_t \quad (6)$$

D. Diagnostic and stability tests

If the model was estimated correctly and is reliable and robust, diagnostic tests ought to be performed to confirm the ARDL model and impartiality. At this stage, heteroscedasticity, serial correlation, and stability tests will be used to evaluate the residuals. If the model does not have any of the biases above, the results generated can be regarded as accurate and suitable for the subsequent process [1].

6. EMPIRICAL RESULTS

A. Descriptive statistics and correlation analysis

This section incorporates the complete descriptive statistics for the series under analysis in this research, including central tendencies, dispersion measures, range, coefficients of kurtosis, and skewness, and the Jarque-Bera statistics. In addition, basic summary of each of the variables used in the study is also presented. The two measures looked at in this section are the center of the statistic and standard deviation, which shows that how much each variable is deviated from the mean in terms of its value. The skewness value of each variable explains the degree of symmetry, the kurtosis statistics of each series shows the peak and Jarque-Bera statistics of each variable shows its normality [10].

Table 2: Descriptive statistics & correlation analysis

Variables	TB	ER	GDPG	M2	INF	FD
Mean	-1.7182	75.1864	4.3406	46.6494	8.7173	6.2477
Median	-0.2141	59.4769	4.4387	45.7602	8.3795	6.3000
Maximum	11.3800	279.5300	7.8312	58.8676	29.2456	8.8000
Minimum	-12.0400	15.3600	-1.2740	34.7994	2.5293	2.4000
Std. Dev.	4.0432	57.8970	2.1244	5.7863	4.9977	1.6694
Skewness	0.2994	1.5150	-0.4086	0.0022	1.8958	-0.3177
Kurtosis	5.6903	5.4829	2.9939	2.2049	8.6304	2.1588
Jarque-Bera	12.6614	25.5774	1.1131	1.0534	76.7973	1.8520
TB	1					
ER	0.7939	1				
GDPg	-0.2839	-0.3844	1			
M2	0.3774	0.3885	-0.2222	1		
INF	0.3811	0.4451	-0.4441	0.1158	1	
FD	-0.2086	0.0446	-0.1279	-0.0831	0.3498	1

Source: Calculations by E-views

In Table 2, all variables are normally distributed with each other. In the correlation matrix positive sign denotes a positive correlation and a negative sign denotes a negative relationship between two variables.

B. Unit root tests

Study used Augmented Dickey-Fuller and Phillips Perron unit root tests to confirm that all variables do not integrate to order I(2). Findings are presented in table 3.

Table 3: Results by using trend and intercept

Variables	Level		First Difference		Order of Integration
	ADF	PP	ADF	PP	
Trade Balance	-1.939532 0.3114	-1.600874 0.4726	7.838590 0.0000	-8.112703 0.0000	I(1)
Exchange Rate	2.389835 1.0000	3.554877 1.0000	-4.158098 0.0023	-4.194574 0.0020	I(1)
GDP Growth	-4.828505 0.0003	-4.828505 0.0003	-7.715464 0.0000	-11.87151 0.0000	I(0)
Broad Money	-5.076014 0.0001	-5.028470 0.0002s	-7.742547 0.0000	-21.93146 0.0001	I(0)
Inflation	-2.061620 0.0376	-1.201049 0.0271	-7.449372 0.0000	-7.434078 0.0000	I(1)
Fiscal Deficit	-2.595947 0.1024	-2.520978 0.1184	-7.684172 0.0000	--8.236937 0.0000	I(1)

Source: Calculations by E-views

In Table 2, all variables are normally distributed with each other. In the correlation matrix positive sign denotes a positive correlation and a negative sign denotes a negative relationship between two variables.

C. Bound test analysis

Pesaran et al. (2001) created the ARDL bounds testing strategy, a cointegration method, to test for a long- term link between the variables [4]. Estimated values of bound test results have been given below:

Table 4: Bounds test results

Test Statistic	**Value**	**K**	
F-statistic	9.882341	5	
Bound Test Values			**Remarks**
Significance	I(0)	I(1)	
10%	2.08	3	Ho : Reject (No cointegration)
5%	2.39	3	H1 : Reject (cointegration exits)
2.5%	2.73	3.73	
1%	3.06	4.15	

Source: Calculations by E-views

Table 4 presents the findings, which indicate that F-statistic of 9.8823 is higher than the upper bound values for 1%, 2.5%, 5%, and 10%. This implies a long-term relationship between variables under investigation and shows that the study supports the existence of cointegration. Based on the data, we will accept the alternative hypothesis, which suggests cointegration in the model and long run relationship exists between the variables.

D. Results of long run analysis

In this section, long run relationship between selected variables has been discussed with estimated values y using ARDL technique

Table 5: Results of exchange rate and trade balance

Dependent Variable: Trade Balance (TB)				
Regressors	**Coefficient**	**S.E**	**t-Statistic**	**P-value**
ER	-0.103309	0.013742	7.535262	0.0003
GDPg	0.872334	0.277332	3.146123	0.0199
M2	-0.319302	0.890291	-3.585344	0.0116
INF	0.530010	0.088813	5.965626	0.0010
FD	-1.162602	0.123129	-9.444432	0.0001
C	6.7232	2.9573	2.2734	0.0634

Source: Calculations by E-views

The ARDL long-run coefficients computed in Table 5 indicate that there is a positive association between GDP growth, inflation, and fiscal deficit with the trade balance of Pakistan in the long run. The currency rate and wide money have a negative correlation, which has a negative effect on Pakistan's trade balance. All of the chosen factors have a substantial influence on the trade balance.

E. Error correction model (ECM) results

In this section, long run relationship between selected variables has been discussed with estimated values y using ARDL technique James Davidson, David F., and other economists introduced the time series regression model and the error correction model to the field of economics. Error correction model (ECM) has been estimated to examine the effet of exchange rate and other selected macroeconomic variables on trade balance in the short run. In table 6 short run results has presented:

Table 6: Error correction representation for the selected ARDL model

Regressors	**Coefficients**	**SE**	**T-ratio**	**P-value**
D(TB(-1))	1.025173	0.172995	5.926034	0.0010
D(TB(-2))	-0.146551	0.122778	-1.193628	0.2777
D(TB(-3))	-0.306286	0.136420	-2.245171	0.0659
D(ER)	-0.095923	0.028912	-3.317734	0.0160
D(ER(-1))	-0.253057	0.037276	-6.788701	0.0005

D(ER(-2))	-0.426341	0.049224	-8.661304	0.0001
D(ER(-3))	-0.272093	0.050357	-5.403272	0.0017
D(FD)	-1.228579	0.153286	-8.014934	0.0002
D(FD(-1))	1.900852	0.244979	7.759252	0.0002
D(FD(-2))	2.091232	0.241367	8.664127	0.0001
D(FD(-3))	1.657500	0.211713	7.828993	0.0002
D(INF)	0.236689	0.072033	3.285841	0.0167
D(INF(-1))	-1.493497	0.153360	-9.738513	0.0001
D(INF(-2))	-1.029735	0.111061	-9.271790	0.0001
D(INF(-3))	-0.438288	0.083300	-5.261555	0.0019
D(GDPG)	0.073427	0.111413	0.659057	0.5343
D(GDPG(-1))	-2.128845	0.232028	-9.174968	0.0001
D(GDPG(-2))	-1.358111	0.153601	-8.841823	0.0001
D(GDPG(-3))	-0.881136	0.125659	-7.012135	0.0004
D(M2)	-0.239949	0.089317	-2.686477	0.0362
D(M2(-1))	-0.016481	0.057948	-0.284403	0.7857
D(M2(-2))	0.122569	0.055275	2.217443	0.0684
D(M2(-3))	0.211081	0.064005	3.297907	0.0165
Coint Eq(-1)	-2.781638	0.236487	-11.76235	0.0000
R^2 = 0.9686; Durbin-Waston Stat 2.6581				
Adjusted R^2 = 0.9085				

Source: Calculations by E-views

All of the chosen factors have a substantial influence on the trade balance. Coefficient of error correction model is statistically significant at 1% level with correct sign (negative). Results of ECM shows that the disequilibrium observed in the model can be corrected within three months approximately.

F. Diagnostics and stability tests

A lot of diagnostic tests were carried out in an attempt of determining the health of the series. The components of the analysis are also the test of serial correlation employing the Breusch-Godfrey LM test as well as heteroscedasticity test. The findings further indicate that the specified model used to conduct the study does not have serial correlation and is homoscedastic – thereby signifying stability of the model and compliance with the diagnostic checks. Regularity of the long-run coefficient is determined in assessing the short term movement. CUSUM and CUSUMSQ tests are used for tackling problems relating to structural breaks where the data is of a large size; as highlighted by Pesaran and Pesaran (1997) [1].

Table 7: Diagnostics and stability tests results

Test	**X^2 (p value)**	**Results**
Breusch-Pagan-Godfrey	0.5204	No heteroscedasticity issue
Ramsey RESET Test	0.2056	Model is specified correctly
Normality Test (Jarque-Bera)	0.8738	Estimated residuals are normal
CUSUM	Stable	Parameters are stable
CUSUMSQ	Stable	Parameters are stable

Source: Calculations by E-views

All of the chosen factors have a substantial influence on the trade balance. Coefficient of error correction model is statistically significant at 1% level with correct sign (negative). Results of ECM shows that the disequilibrium observed in the model can be corrected within three months approximately.

7. CONCLUSION AND RECOMMENDATIONS

To examine the relationship between current rate fluctuations and trade balance of the Pakistan economy, this research focuses on the yearly data from 1984 to 2023. Study examine the short- and long-term connections between these major economic variables within an autoregressive distributed lag (ARDL) context using bound testing method on cointegration and error correction models. Majority of empirical results are significant and offer insights as to the complicated association between exchange rate volatility and Pakistan's trade balance. Empirical findings reveal that Pakistan's trade balance is positively and significantly affected by inflation, GDP growth and exchange rate oscillations. This infers that devaluation of the currency reduces import costs and decreases export costs thus enhancing the trade balance. Similarly, a higher GDP growth rate is indicative of a developing economy that boosts the capacity of producing and exporting goods and thus improving on the trade balance. A slight inflation can also lead to increase in export competitiveness by showing that local prices increase with a slower rate compared to the prices in other countries.

On the other hand, the negative and significant coefficients for broad money suggest that an increased money supply leads to reduced domestic demand and imports thereby worsening the trade balance. Moreover, a scenario of large budget deficit is also unfavorable to the trade balance because it usually leads to government borrowing. This may lead to a better currency and higher interest rates which may affect export business in one way by making it less competitive. This outcome shows why it is necessary to pursue stability of the monetary and fiscal policies in order to enhance Pakistan's trade balance.

Thus, influence of exchange rate fluctuations in the country led the research propose that government should adopt a controlled float exchange rate policy. In addition, the government has to encourage and improve the quality of manufactured products and services. Thus, there is only one way for a country to affect its currency and balance of payments – by creating an international demand for its goods or by decreasing its demand on foreign goods. In an attempt to increase our nation's production capacity to support local needs and export surplus to the international market, it is only appropriate that the government encourages and facilitate its citizen to acquire comprehensive information to key production processes.

Due to the twin deficits, exchange rates instability in Pakistan requires integration of balance of payment and fiscal policies for achieving the goal of macroeconomic stability. Special measures and effective tool of the exchange rate may help to mitigate external impacts and exclude the sharp fluctuations of a currency. Policy measures that are aimed at reducing fiscal deficit include expansion of tax base in addition to the improvement of efficiency of government expenditure. The advancement of export diversification and enhancement of the competitor aspect of home sectors through offer incentives as well as engineering can assist bring stabilisation in the trade balance. Fiscal policy can also be enhanced by the monetary policy to reduce inflation and to reduce the impact of the devaluation on the import costs.

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