CHAPTER

I

INTRODUCTION
1-Introduction

Foreign Trade sector is one of the most important sectors of an economy. An improvement of this sector in any country can be an important factor for economic growth. Although, imports are considered as one of the factors of economic growth, the impact of which is apparently negative, but under certain specific conditions, it can also help improving the economic situation and livelihoods in a country.

As we know, for the imports we need foreign exchange. The foreign exchange is obtained from exports. Iran needs to obtain at least 80 Billion dollars in a year and without an improvement in oil revenues, it is impossible. Therefore, the country either should increase the non-oil exports follow various ways reduce the country’s imports.

Unnecessary imports in the form of luxury goods are taking a lot of foreign exchange in the country therefore leading to a reduction in national income. Thus, Iran requires the following steps: reduction of non-oil exports, reducing dependence on various sectors of agriculture, industry and mining, development of small and medium industrial towns. In addition, increase the quality of domestic products and reduce competitive ability.

Also it should join the World Trade Organization, and to reduce the irregular imports and exports. Imports should be such that there is minimum negative
impact on the economy. Thus the aim for foreign exchange policy should be in such a way that does not make significant long-term imbalance.

Real exchange rate is a basic and an important variable in different sectors of the economy especially the foreign trade sector and this rate has always been very important. One of the major factors used in this analysis is relationship between the real effective exchange rate (REER) and imports. One of the main factors forming the economy and economic behavior in some developing countries such as Iran is oil income i.e. most of the major financial sources of government and revenue and major sources of foreign exchange in these countries.

Exchange rate, regardless of titles like formal, floating, and the black market and etc from the perspective of the real exchange rate is notable.

Real exchange rate in a simple definition represents the real value of goods and services of a country at international level and with its direct effect on other variables changes the balance of payments in the country.

To understand the import status, it can generally be divided into two groups. First manufacturing and capital goods. Second importing consumer goods.

**1-Imports of Manufacturing and capital goods:** Imports of Manufacturing and capital goods is permitted due to their importance for the economy, as there is no possibility of production domestically, because it ultimately helps to produce and improve the economic situation.
2- **Consumer goods**: Especially Ephemeral consumption, this type of imports can be injecting various effects on a country's economy.

In Analysis of imports and balance of payments of countries such as Iran, the role of the state's economy is Significant. The wheels of the economy move based on direct government intervention in the economy and it has the main role to affect the variables that have a direct effect on imports.

Factors affecting imports are generally divided into two categories.

**I-The major factors that affect imports include:**

1-1 - The demand of people for imported goods.

1-2 - Lack of supportive government policies of manufacturers.

1-3 - The lack of stability and economic safety.

1-4 - A lack of development in investment in infrastructure in various economic sectors.

1-5 - The lack of diversity in domestic production Appropriate whit the tastes of people.

1-6 - Lack of appropriate culture in against imported goods.

1-7 - Lack of competitiveness in the domestic price compared to similar imported.

1-8 - Lack of exchange rate stability.

1-9 - The role of Free Zones in the development of imports.
1-10  - Beautiful and appropriate packaging of imported goods.

1-11  - Lack of effective control on the phenomenon of trafficking.

II- Major factors that can help to prevent the import include:

2-1- Increase exchange Rate.

2-2 - the lack of a coherent monetary and financial system in the country.

2-3 - Legal and regulatory matters.

2-4 - Domestically produced goods instead of imports.

2-5 - increased cost of transportation.

2-6 - To increase tariffs.

2-7 - a serious collision with a smuggler.

2-8 - the production with high quality and suitable with taste of people.

As we know, on the other hand, growths of GDP of other countries that have been our Business partners directly influence our imports.

The Country’s import of goods and services means import of foreigners. With an increase in GDP, the demand for goods and services also increases in general in turn reducing the foreign exports which are the same as our imports. Therefore this study investigates the relationship between variables real effective exchange rate (REER) and world GDP (WGDP) with value of imports (IV).

1-2 - The Problem Statement

In most developing countries, monetary policies have been designed to be able to
achieve balance in the trade balance and also exports expansion. As we know, one of the ways to achieve sustainable development is import substitution and export promotion. Determining the value of national currency (increase or decrease) is the most controversial cases in most developing countries. The national currency value directly affects the real exchange rate and real exchange rate fluctuations cause abnormality in the relative prices of consumer goods (basic) and intermediate and the import of capital goods also affect the exports. This case has undesirable effect on the Changes of economic behavior of firms. For example, reduce the real exchange rate can reduce the price of imported goods and capital and also reduce the use of internal labor. As a result, imports of capital become more affordable. Reduction in producing and using domestic products consequently increases the unemployment reducing consumption and ultimately will reduce welfare.

The optimistic view: Exchange rate increases imports of capital goods and intermediate requirements of domestic industry which increase the investment create new production capacity in turn increases employment, consumption and welfare to be followed. Thus Currency and exchange control policies, the critical factors affecting the control exchange rate which can act as a double-edged sword to Profits or losses to the economy.
During the years, Iran has been dependent on oil revenues and foreign exchange that was achieved from selling oil and the foreign exchange earnings from oil exports has been sources for the import of capital goods, intermediate inputs and raw materials. Thus oil price and exchange rate have direct effects on investment and consumption causing an increase or decrease in the GDP.

A review of empirical works on effects of changes in real exchange rate and world GDP on imports can answer the question that whether, exchange rate changes and its policies (especially in the years after the revolution) have helped the growth of the national economy or not. For example, a group of economists believe that devaluation can reduce the import resulting in increased domestic production in the country. But a group of empirical studies have confirmed the effects of Shrinkage devaluations of national economy. On the other hand effects of changing the official exchange rate on imports, although it can provide information to analysts but cannot represent all the facts.

2- Significance of the Study

Primarily, trade with other countries is one of the factors in economic growth. On the other hand income of a country’s trading partner and real exchange rate are the main factors affecting the foreign trade and mal-adjustment of real
exchange rate which can make real exchange Rate play a determining role of exports and imports through the impact on international competitiveness.

Previous studies show that the real exchange rate fluctuations and deviations from balance rates in most of the less developed countries have caused great economic hardship. Real exchange rate is one of the factors that directly affect economic performance. Any negative or positive change affects the exchange rate. If a country has a predetermined exchange rate regime, and exchange rate doesn’t adjust with economic changes, it will be considered non-real exchange rate. This will have negative impact on balance of payment which makes it a lot difficult for the foreign sector of the country.

To show the importance of imports, we can survey Overview on effects of this variable on key sectors of economy and its effects on major problems of society. In this section an overview of the effect of import value of each of the following variables is made.

2-1 - Investment: An increase in imports can be two categories of commodities and manufacture goods. Imports of consumer goods reduce investment and domestic production but import of manufactured goods can cause more production and more investment in the country.

2-2 - Production: Import of consumer goods reduce domestic production and import of capital goods, the raw materials and intermediate goods increase
domestic production and in the long-term causes increase in domestic consumer welfare.

2-3 - Economic instability and reduced foreign exchange earnings: Imports increase leads to reduce of resources of foreign exchange and also will reduce Supporting currency of country and eventually lead to economic instability.

2-4 - Dependence on foreign countries: The import of any kind that may cause dependence, especially if these imports be capital goods, the raw materials and intermediate goods.

2-5 - Employment: Imports can reduce production and reduced production means reduced employment, so imports cause to reduce employment.

2-6 - Inflation: Import of goods and services from abroad causes a decline in domestic prices and eventually reduce inflation that inflation is same price growth.

3- Objectives:

The main objectives of the study are as follows.

3-1 – Calculate, study and analyze the trends of world economic growth (GDP of the country's major trading partner of Iran during 1962-2011).

3-2 – Calculate, study and analyze the trends in real effective exchange rate for the years 1962 to 2011 in Iran.

3-3 – To study the process of changes in the real exchange rate of Iran, world
economic growth (WGDP), Iran’s GDP, Iran’s inflation and finding a significant relationship long-term between real effective exchange rate, world economic growth, Iran’s GDP, Iran’s inflation and Iran's imports value.

4-Hypotheses:

The main hypotheses used in this study are:

4-1 – Iran’s imports have a negative relationship with the real effective exchange rate (REER).

4-2 - Iran's imports have positive relationship with global economic growth, Gross Domestic Product and Iran’s inflation.

4-3 - The imports growth will increase by reducing exchange rate and Iran will not benefit from the policies of imports growth.

4-4 – There are some structural breaks in the real exchange rate, global economic growth and the value of imports of Iran.

5-Limitations of Study

This is an empirical study based on secondary sources of data. The problems relating secondary data apply to the work. The data on inflation are scarce. Most of the countries don’t have comparable data on above variables. This is the reason why many studies rely on simple and often static comparisons of data.
Other studies analyze the pass-through of exchange rates to import and export prices because this data is more readily available.

6-Methodology

In the beginning I will start with the existing theoretical literature, select appropriate methods to calculate the real exchange rate and global economic growth and calculate their values.

Survey Effects of REER, WGDP, IFN and IGDP on IV without using a suitable economic model in which different effective variables is impossible.

In this study, using such a model to summarize and obtain an equation that involving REER, WGDP, INF, IGDP and IV and other variables that can influence and estimation of this equation with co-integration method and try to analysis long term relationship between REER, WGDP, INF, IGDP and IV.

6-1- Sample Selection

1 – For calculation of global economic growth (GDP of the country's major trading partner of Iran) and Calculate the real effective exchange rate, we will use data of India, Japan, united Arabic emirates (UAE), France, Canada, Italy, Turkey, Denmark, Switzerland, Belgium, Germany, Britain, Austria, Pakistan,
China, Korea. These countries were chosen because during the period studied, these countries, have the highest share in Iran’s foreign trade.

6-2-Data Sources:

The study will be carried out using secondary data.

Secondary Data:

The secondary data will be collected through the following sources.

1-International monetary fund (IMF)
2-International financial statistics (IFS)
3-National central banks of countries
4-Centeral statistical organization of countries
5-UN comrade

Most data used in calculating gross domestic product and data needed to calculate the real exchange rate have been obtained from the International Monetary Fund (IMF) and data relating to imports extracted from the annual reports and balance sheets of the Central banks that includes annual data for the period 1962-2011 for Iran.

Other statistics and information using the Internet (particularly the statistics relating to countries other than Iran) and various statistical yearbooks and reports
have been prepared by the Central Bank and the Management and Planning Organization.

**6-3-Period of Study:**

The required data on invoicing currency was collected for the period of 1962 to 2011.

**6-4-Statistical Tools**

In order to study relationship between variables we will use regression and correlation. More specifically we use co-integration methods developed by Gregory_- Hansen.

**6-4-1- Relative contribution of factor inputs to outputs:**

To study the contribution of factor input ie, value of imports and value of exports to output, a regression; \( Y = a + B_1X_1 + B_2X \) while \( Y \) refers to import and \( X_1 \) refers to REER and \( X_2 \) refers to WGDP

**6-4-2- Software**

To calculate the real exchange rate of Software office excel used for calculate REER and for estimation the coefficients of the model, software Microfit and software E-views are used.
7-Chapter Scheme:

The first chapter is on introduction which includes objectives, hypotheses, and a detailed methodology.

The second chapter is on review of literature.

The third chapter is on theoretical foundations necessary to introduce the basic concepts that are needed in this research such as co-integration, estimation of the break-point, Unit root tests and co-integration tests.

The fourth chapter is a review of Iran’s exchange policy in recent decades. Then with the calculation method of REER And WGDP for use in research and its calculation, to review and analyze of Process of changes real effective exchange rate, global economic growth and the value of imports and their relations in Iran economy.

The fifth chapter introduces the econometric model to investigate the long-term relationship. Significantly between REER, WGDP, INF, IGDP, IV, And using existing theoretical Basics in the third chapter, unit root tests, Dickey - Fuller, Peron unit root tests and estimates of break-point and co-integration tests with respect to structural breaks.

In sixth chapter, the empirical results obtained with the method of estimating the integration model, the overall conclusions and review results and recommendations are based on these results are presented.