CHAPTER I

INTRODUCTION

Economic development is one of the main objectives of every society and very often, economic growth is seen as fundamental to economic development.[1.1] In the literature on trade, aid and development, it is often assumed that both trade and aid are factors which have an influence on the domestic growth. As a result, the impact of policy reform on economic performance is still very much a topical issue in developmental economics. Since the middle 1970, there has been considerable progress in trade reform in most developing countries, turning from an import substitution (IS) strategy to an export promoted (EP) policy.[1.2] This shift towards industrialization favor openness is observed in Newly Industrializing Countries (NIC's). In the 1980s and 1990s, there have been dramatic increase in both trade and foreign direct investment (FDI) flows in the more dynamic economies of the region, particularly in countries such as Malaysia. For instance, total export increased from 28,172 millions Ringgits in 1980 to 197,026 millions Ringgits in 1996, whereas, FDI rose from 729 millions Ringgits in 1980 to 17,056 millions Ringgits in 1996.[1.3]

[1.1] Anwer and Sampath (2002)
[1.2] Alguacil *et al.* (2002)
[1.3] Data extracted from Monthly Statistical Bulletin and International Financial Statistics published by Bank Negara Malaysia and International Monetary Fund respectively.

1.1 Historical Background

After independence in 1957, Malaysia was one of the new politically independent developing countries to view industrialization as a road to development. Industry was seen as a key to the accumulation of wealth and the engine of growth. During this time, the industrialization process placed emphasis on IS where some goods were domestically produced rather than imported. The simplest way to do this was to impose restrictions on imports.[1.4] According to Bruton (1970), this would create gaps in the economy that make for investment opportunities in non-traditional activities of the economy, usually manufacturing. Resources are directed into new industrial sectors and expected profits may lead to a rise in the saving rate and this will result further increase in investment.

However, the IS strategy did not last long after many shortcomings arose. For instance, it was argued that due to protection and subsidy policies, there exist many small firms in one industry producing for a small domestic markets leading to uneconomic scale of production. It has also worsened by the lack of competition and incentives to improve the production technique. Small firms are reluctant to change as it involves financial resources, knowledge and manpower. Hence it dampens productivity growth and also curbs the incentives to catch up with international competitors.[1.5]

In early of 1970s, Malaysia shifted from an IS approach to an EP strategy. This was partly due to the ineffectiveness of IS policy, and also impressive performance of

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[1.4] Alavi, R (1996)
[1.5] Alavi, R (1996)

the NICs, particularly in East Asia namely South Korea, Taiwan, Hong Kong and Singapore. Their impressive growth was thought to be due to an EP policy. Consequently, the government emphasized EP as a way to improve the allocation of resources and to overcome the shortcomings resulted from IS.

In order to promote EP industrialization, the government implemented export incentives which include tariff and tax exemptions, production loans for exporters, direct export subsidies, credit for overseas marketing, etc. Besides that, government also established export processing zones (EPZs) where EPZs are special enclaves, outside a nation's normal custom barriers within which investing firms, mostly foreign, enjoyed favored treatments with respect to imports of intermediate goods, company taxation, provision of infrastructure, and freedom from industrial regulation applying elsewhere in the country.[1.6] These in turn encouraged and attracted more inflows of foreign capital funds.

The consequences of structural changes on economic performance have been of interest to developmental economists. With the implementation of export-oriented policy, the effect of this liberalization process, through its openness, has an influence on the output level and subsequently on the growth of the economy, that is, the export-led growth (ELG) hypothesis.[1.7]

However, the above mentioned only involves bivariate analysis. There had been a fast growing rate of the inflows of the capital funds, which exceeding the rate of the

[1.6] Alavi, R (1996)
[1.7] Alguacil *et al.* (2002)

international trade during the last two decades, yet, inclusion of FDI inflow into the analysis is yet to be realized. Therefore, focusing only on trade as a proxy for openness may be misleading.[1.8]

Of late, there is an increased agreement that FDI promotes growth, that is, FDI-led growth hypothesis (FLG). FDI is often seen as an important catalyst for the economic growth not only provides financing for the acquisition of new plants and equipments, but also in the transfer of knowledge and organizational forms from relatively more technologically advanced economies. Besides, it could also result in a positive spillover to the local economy through the linkages with local supplier, competition, imitation and training.[1.9]

As a result, the interlinks are interesting but yet to be explored. Most of the previous studies have concentrated on exports-growth relations, few have studied FDI-growth link. Empirical studies which include all relations, only have recently examined by Alguacil *et al.* (2002) and Liu *et al.* (2002). Hence, it is important for government to consider and evaluate effective policies, especially with the emergence of China into the world market, to achieve favorable growth rate as we try to achieve developed status by 2020.

[1.8] Goldberg and Klein (1999)

[1.9] Positive spillovers include improved productivity, technology and knowledge, positive externalities, etc. However, there could be negative spillover effect if it forces domestic enterprises to close down due to inability to obtain necessary financing for upgrading their technology. Possible spillover effect may not occur too if there are institutional obstacles or deficiencies in the absorptive capacity of domestic enterprises. (Economic Survey of Europe, 2001)

1.2 Objectives of the study

The main objective of this study is to conduct causality tests among trade, FDI and economic growth in Malaysia using Toda and Yamamoto's (1995) notion of Granger non-causality. Although relationships between exports and growth, and between FDI and economic performance have been explored, the interrelationship between trade, FDI and growth has yet to be analyzed. Hence, the estimated results would be interpreted with a view towards policy suggestions to improve or assist our economy to achieve its favorable growth rate.

1.3 Organization of the study

This study consists of 6 chapters. This chapter presents the historical background and objectives of the study to acting as a synopsis of the study.

Chapter II describes the literature related to the study. Table 2.1 summarizes the empirical findings on the relationship between export and growth, whereas, summary of the studies on FDI-growth nexus is presented in Table 2.2. Table 2.3 specifically summarizes the selected empirical studies of these relationships done in Malaysia. Lastly, Table 2.4 shows the review of the studies which have employed Granger's procedures.

Chapter III provides the theoretical framework which acts as a benchmark to ensure the methods employed are consistent with the theory.

Chapter IV states the methodology and data used in this study. It includes unit roots test of stationarity and Toda and Yamamoto's (1995) test of Granger non-causality.

Chapter V analyzes the results offering discussions on the estimated output. Subsequently, Chapter VI concludes our discussions which consists of a summaries of the empirical evidence and implication of the results, and recommendations for further research.