

CHAPTER ONE: INTRODUCTION

1.1 EXPORT-LED INDUSTRIALISATION: AN OVERVIEW

The relationship between exports and growth is at the heart of a debate on the selection of a country's industrialization strategy. Though seldom rigorously formulated, the export-led growth compared with the import-substitution strategy is often cited as the main reason for observed differences in the development patterns and performance among less developed countries (**Rana, 1986; Salvatore, 1998**).

A very common question that is often asked is whether international trade leads to economic development. The more or less standard answer since the nineteenth century has been 'yes'. Such opinions are based on the theory of comparative advantage which argues that if countries specialize in what they can produce more efficiently and leave to other nations what they can produce with less efficiency, then real output, income and consumption will be higher than what it would have been without international trade (see for example **Balassa, 1978; Jung and Marshall, 1985**). Furthermore, the higher level of consumption implies a larger domestic market, increased specialization, greater economies of scale and higher capacity utilization. Also, the higher income encourages investment in domestic production. The wider markets and larger investment, in turn, lead to even higher income, with further rounds of economic stimulation. In this sense, trade is seen as an engine of growth.

In the absence of trade, each country can consume only what it produces. There is no way that a country can reach a point of consumption outside its production possibility curve.

This is only common sense, for how can a country's consumption ever exceed its production! Yet in the comparative advantage theory, this is just what can happen if trade takes place among countries. The theory of comparative advantage emphasizes that gains from trade for one country are not losses for another. In the model of comparative advantage, trade is a positive sum game in which both participants gain.

Moreover, many economists believe that the main advantage of international trade is not its static gain but the dynamic gains of changing factor proportions and hence changing comparative advantage. In the process of dynamic change, production experience for both labour and management is thought to be important. Experience, often called 'learning-by-doing' may lower costs leading to a new comparative advantage which allows some former imports to be produced at home as well as allows new exports. Learning-by-doing is now believed to be an especially important element of gains from trade (**Bhagwati, 1988**).

However, such views have been strongly challenged. Many economists (**Frank, 1970; Rodney, 1972; Santos, 1970**) argue that trade itself is the cause of underdevelopment of many countries. According to these economists, trade is neither engine nor expeditor of growth. This school of thought believes that firstly, unequal exchange may be the result of trade. Secondly, they argue that because of a low multiplier effect from trade, exports of the less developed countries may fail to stimulate development. These are known as the enclave or backwash arguments. Proponents of the backwash arguments often agree that trade may benefit all, but some countries will gain far more than others. An initial comparative advantage in manufacturing tends to be self-perpetuating, so locking less developed countries (LDCs) into permanent and less profitable production of agricultural

goods with very limited impact on the domestic economy (**Griffin and Gurley, 1985; Santos, 1970**). Thirdly, these economists argue that due to the low income elasticity of agricultural products, the prices that these LDCs enjoy for their exports tend to fall leading to a deterioration in these countries' terms of trade.

All these arguments about trade when taken together are called 'dependency theory' (see **Salvatore, 1998**). According to the latter, trade locks LDCs into an inferior and worsening position in a world trade system dominated by, and for the benefit of the rich. Therefore, according to them a revolutionary change in trading relations is required (see **Griffin and Gurley, 1985; Santos, 1970**). Ending dependence is synonym for throwing off poverty and the suggested strategy aims towards inward-looking self-reliance.

Even assuming the superior performance of export-led growth strategy, there is still active debate about the mechanisms through which policies under ELG strategies contribute to growth. All the mechanisms through which export promotion translates into higher growth share a common feature. They all argue that export growth causes output growth. Thus, the ELG hypothesis should be taken to be not only an assertion of correlation, but also an assertion of causation. Ordinary correlation between export growth and output growth is not able to distinguish between the export promotion hypothesis and the growth-led exports hypothesis (**Jung and Marshall, 1985**). A discriminating test of the export promotion hypothesis should, therefore, focus on the direction and sign of the causality between exports and growth. Recent studies investigating the exports-growth relationship go beyond looking at the significance of the coefficient of exports and address the issue of the direction of causation using techniques in the Granger (1969) framework (see **Jung and Marshall, 1985; Chow, 1987; Kunst**

and Marin, 1989; Ahmad and Kwan, 1991). The test procedures adopted in these studies have certain advantages over the simple contemporaneous correlation-based tests that are used to examine the export promotion hypothesis. The use of temporal information in these test procedures allow them to examine the direction of causation.

1.2 BACKGROUND ON MALAYSIAN TRADE AND INDUSTRIAL POLICIES

Currently, Malaysia is considered as a newly industrializing country (NIC) and one of the most successful developing countries (**World Bank, 1993**). Its goal is to be fully developed by the year 2020. The strategy to achieve this aim is through further industrialization.

Until mid-1997, Malaysia was acknowledged to be one of the most dynamic countries in the world, having achieved a high and sustained level of economic performance. Malaysia is largely endowed with natural resources and is a major producer of palm oil, rubber, tin and petroleum. In the earlier decades, a large component of its exports was resource-based and it competed in the world market as an exporter of primary products.

One key feature of Malaysian trade is that of its changing composition. The Malaysian export structure has shifted considerably away from the traditional primary products towards more dynamic manufactures in response to depressed commodity and energy prices. Exports also switched from resource-based products such as processed food, beverages towards textile and clothing, chemicals and electronics.

Malaysia embarked on industrialization in the late 1950s and early 1960s and the government played an active role in initiating and quickening its pace and in influencing

its direction and pattern. Industrialisation in Malaysia started with import-substitution, with the use of tariffs and quantitative restrictions focusing initially on final consumer goods for which domestic demand was manifest, followed later by intermediate and capital goods. Import-substitution helped the Malaysian government to initiate industrialization and nurture industrial entrepreneurship to a great extent. However, the very common problems of inefficient import-substitution industries as well as the need for export earnings led to the switch to export manufacturing.

In the first half of the 1990s, the globalisation of information and communication fuelled demand for semi-conductors, personal computers, cellular phones and other telecommunication equipment. As a result of which electronics contributed significantly to the sharp growth in global trade in manufactures. Likewise, electronics came to dominate Malaysia's exports, accounting for about 50% of its exports (**Yearbook of Statistics, 1996**). However, the 1996 global recession in semi-conductors and the slump in demand for electronics adversely affected the Malaysian exports. The growth rate of the latter fell from 26.6% in 1995 to 7.3% in 1996 and 6.0% in 1997. Apart from the downturn in the global market for electronics, this drastic slowdown in exports was also caused by a loss of competitiveness due to the pegging of the domestic currency to a strong US Dollar.

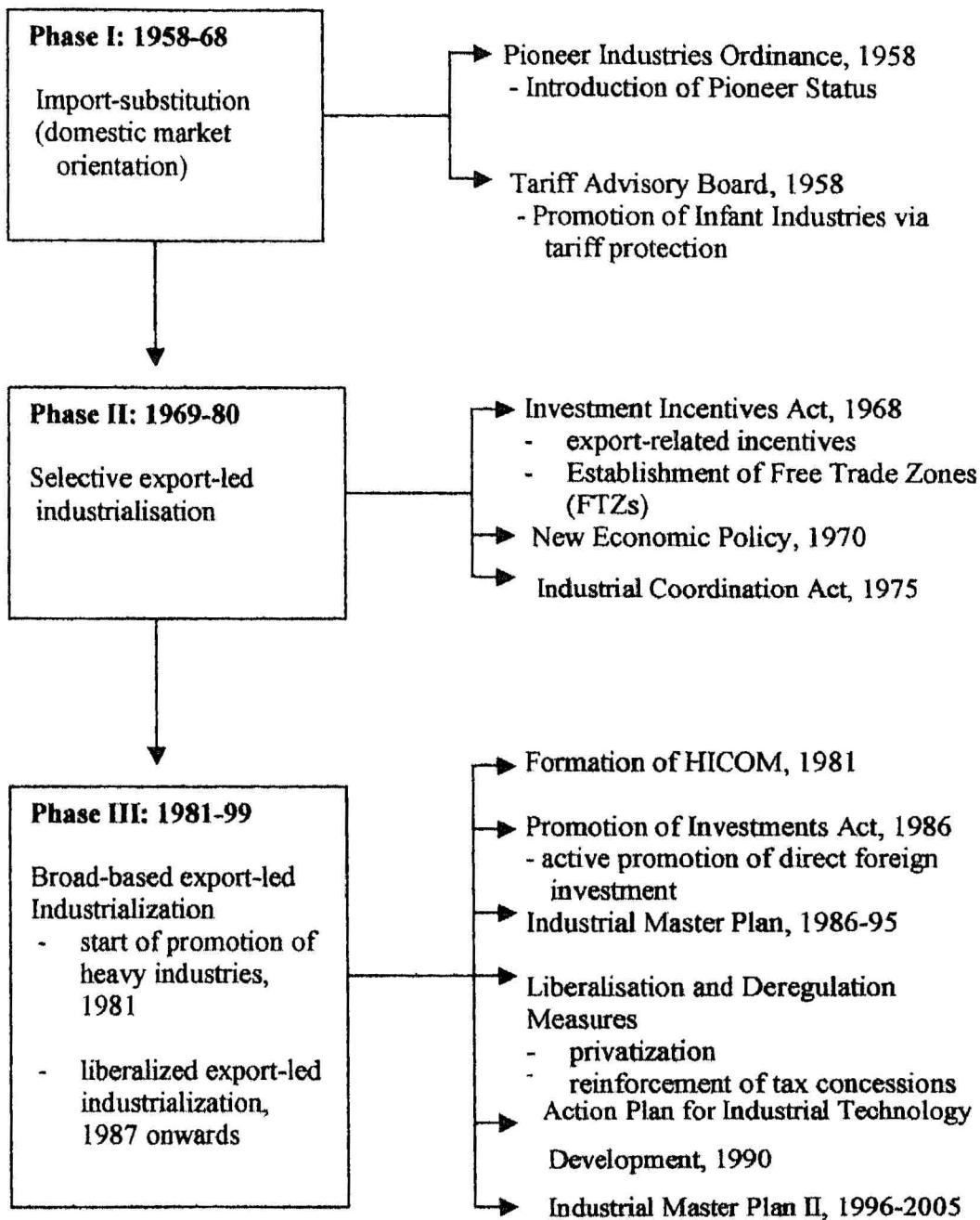
Malaysia's industrial drive was marked by three distinct phases as shown in chart 1 on the next page. The policy initiatives taken have generated employment and contributed significantly to the nation's well-being ¹.

1. Islam et al. (2000)

CHART 1: INDUSTRIAL DEVELOPMENT & POLICY INITIATIVES IN MALAYSIA, 1958-99

INDUSTRIALISATION PHASES

KEY ENABLERS



source: Bank Negara Malaysia Annual Report, 1999
Islam et al. (2000)

Thus, from the above discussion, it can be said that trade acts as the life-blood of the Malaysian economy. The fortunes of Malaysia are closely tied to that of the global economy through trade. Hence, Malaysia owes its prosperity to a large extent to its thriving trade transactions with the rest of the world.

1.3 OBJECTIVES OF THIS PAPER

The main objective of this paper is to establish whether a causal link between exports and economic growth exists for the Malaysian economy based on cointegration and Granger causality techniques.

The reasons for choosing Malaysia as a case study are: firstly, given the important role played by exports in Malaysia, it is worth examining whether these exports have any significant impact on the growth potential of the economy. Secondly, according to many studies², Malaysia, being part of ASEAN 5 comprising Indonesia, Malaysia, Philippines, Singapore and Thailand, has been aggressively pursuing an increasingly outward-oriented, export-led and foreign direct investment (FDI)-led strategy. According to these studies, this has contributed to high growth performance and structural transformation in recent decades as trade and FDI have enabled Malaysia to overcome the constraints of small domestic markets and allowed them to exploit comparative advantage and scale economies.

This paper also tries to find out if a long run relationship exists between exports and

2. see Chia Siow Yue (1999), Bank Negara Malaysia Annual Report 1999: Reinhardt (2000)

economic growth in Malaysia and thus whether export promotion strategies adopted have the potential of bearing growth in the future.

1.4 ORGANISATION OF THE PAPER

The rest of this paper is organized as follows:

Chapter Two deals with the theoretical background and existing empirical evidence underlying the export-growth relationship. Based on the theoretical and empirical literature of Chapter Two, two regression models will be developed in Chapter Three. In Chapter Four, an outline of the econometric theory underlying stationarity tests - Dickey-Fuller (1979) and Augmented Dickey-Fuller (1981) tests will be given. In addition to the above unit root tests, the Engle and Granger (1987) two-step procedure and Johansen (1988) methodology for testing cointegration, Granger causality tests and an error-correction model will be outlined in this part of the paper. Chapter Five will report the results of the various tests mentioned in Chapter Four. An analysis of the results will also follow in this same chapter. Finally, Chapter Six will deal with conclusion and policy implications following the results of the various tests carried out in the previous chapters. This chapter will adopt the causal factor approach based on the results.