CHAPTER - I
INTRODUCTION
1.1 INTRODUCTION:

Trade reforms are the set of economic opportunities by enlarging market size and increasing the effects of knowledge spillover. In conceptual terms, trade reforms work by inducing substitution effects in the production and consumption of goods and services through changes in prices. These effects in turn, change the level and composition of exports and imports. In particular, the changing relative prices induced by trade reforms cause a reallocation of resources from less efficient to more efficient uses. These are the key components of the effects of trade reform, which together induce the growth of a country.

The relationship between trade reforms and economic growth has been the subject for many studies and research projects. It indicates that although trade reforms offer long term benefits for developing countries, trade liberalization alone is not sufficient for economic growth; rather it has become clear that maximizing trade and welfare outcomes depends on the underlying macroeconomic environment, industrial policies for export development, the design and sequencing of trade policies, external constraints and opportunities and complementary policies. Trade policy acts an important instrument of achieving higher and faster rate of economic growth in developing countries. Many theoretical and empirical studies support this fact. India and Malaysia achieved remarkable economic growth through the process of trade reforms and may be viewed as a miracle.

1.2 TRADE REFORMS IN INDIAN ECONOMY

The Indian economy has remained on the high growth path in recent years, despite some moderation in recent growth projections. After independence, India followed the system of a command and control economy to implement the development policies outlined in five year plans. The
principal objectives were to increase aggregate consumption, reduce unemployment, work towards self-reliance, self-sufficiency and reduce social disparities. The priority among these objectives changed from plan to plan. The important measures undertaken in the field of foreign trade during the first five year plans are summarized in the following table.

**TABLE 1.1**
**MEASURES INTRODUCED IN INDIA TO INFLUENCE FOREIGN TRADE DURING 1949-50 TO 1979-80**

<table>
<thead>
<tr>
<th>PLAN</th>
<th>POLICY MEASURES</th>
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<tbody>
<tr>
<td>First Plan</td>
<td>The desire to save foreign exchange reserves was expressed in the first five year plan (1951-1956). To control and regulate exports and imports in the certain select commodities state trading was considered necessary plan.</td>
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<tr>
<td>Second Plan</td>
<td>Since the middle of second five year plan (1956-1961) a series of measures were initiated with the objective of stepping up exports. The measures in questions were fairly widely conceived and included organizational changes, increased facilities and incentives and diversification of trade.</td>
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<tr>
<td>Third Plan</td>
<td>The third five year plan (1961-1966) provided various measures for expanding exports. The plan divided the expanding of exports under two groups namely.</td>
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<tr>
<td></td>
<td>1. General policies</td>
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<td>2. Measures relating to specific commodities</td>
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<td></td>
<td>Further the third five year plan asked for the availability of surpluses for exports at prices competitive with those of other suppliers in international markets. The third plan tried to explore the possibility of supplementing export earnings with external assistance.</td>
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<tr>
<td><strong>Annual Plan</strong></td>
<td>The three Annual Plans (1966-1969) began with the devaluation of rupee on 6th June 1966 to solve the balance of payment problems and trade problem. This was followed by import liberalization policies. The principal policy measures taken with devaluation included liberal import policy for 59 priority industries in which arrangements were made to meet the requirements for raw materials, components and spares in full (initially for six months). Further modifications, adjustments and extensions in export policies were initiated.</td>
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<tr>
<td><strong>Fourth Plan</strong></td>
<td>The Fourth five year plan (1969-1974) stated that export quotas should be kept to the minimum, especially in case of primary agricultural products, unless there were overriding considerations to justify such action. The fourth plan laid stress on adequate provision for modernization and rehabilitation of manufacturing units as part of export promotion efforts in case of traditional exports. For increasing exports of non-traditional items, special emphasis was placed on wider publicity.</td>
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<tr>
<td><strong>Fifth Plan</strong></td>
<td>In order to have sustained level of growth rate of exports during the fifth five year plan (1974-1979), the exploitation of both supply and demand were considered necessary for export of products of manufacturing sector. This plan laid emphasis on tapping markets where India enjoyed distinct locational advantages.</td>
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Source: Economic Survey, Govt. of India (Various Issues)
Some policy reforms had been initiated in the 1980s for the partial liberalization of foreign trade which can be briefly explained as follows:

### TABLE 1.2

**TRADE LIBERALIZATION MEASURES INTRODUCED IN INDIA DURING 1980s**

<table>
<thead>
<tr>
<th>PERIOD</th>
<th>POLICY MEASURES</th>
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| 1980-1981 | i) The import of raw material components and consumables were divided into banned items, restricted items and canalized items.  
ii) The items which did not appear in the above lists were allowed import by Actual users under Open General License.  
iii) Import replenishment licenses were provided to registered exporters to make Indian products more competitive in global markets. |
| 1981-1982 | i) Import replenishment license scheme was extended to all manufacturers whether they were exporting their products directly or through agents.  
ii) Big trading houses and corporate were provided incentives to encourage exports. A new scheme of Trading House was introduced in 1981. |
ii) Efforts to raise productivity of Indian industries to increase exports.  
iii) Import replenishment licenses were made attractive.  
iv) Technological imports were emphasized.  
v) NRIs were given attractive offers to invest in India. |
| 1984-1985 | i) Enhanced access to exporters exporting value added items.  
ii) Import of old machinery, second hand machinery were prohibited with the object to raise productivity & hence production.  
iii) Committee on Trade Policy was set up in July 1984. |
| 1985-1986 | i) Export-Import Policy for three years was implemented.  
          | ii) Computer Software Policy was announced.  
 | 1986-1987 | i) Fourteen thrust sectors were selected for exports.  
          | ii) Promotion of gems and jewellery for exports.  
 | 1987-1988 | i) Giant export replenishment was given to export deals in barter.  
          | ii) Duty exemption schemes for Advance license were enlarged to include all items of inputs.  
          | iii) Further import-export passbook scheme was revamped.  
 | 1988-1989 | Three years policy was announced in March 1988, with greater emphasis on exports.  
          | ii) Inessential and low priority imports were reduced  

Source: Economic Survey, Govt. of India (Various Issues)

Not-withstanding these measures the trade regime in the 1980’s continued to be characterized by the overwhelming presence of the licensing mechanism and a high level of tariffs which protected the economy from external competition. In other words, the decade of the 1980’s witnessed a timid initiative and not the proper beginning of liberalization process in India. India entered the decade of the 1990’s with large imbalances on the internal and external accounts. In 1990-91 all crucial indicators of Indian economy were running in danger zone. To overcome this crisis India introduced wide ranging reforms in economic policies. This led to significant changes in the trade regime as well. Since then, India has brought about distinct changes in its trade policy with a view to create an environment for achieving rapid increase in exports, raising India’s share in world’s exports and making exports an engine for achieving higher rate of growth. The measures that have been taken to achieve this goal can be discussed under the following heads:
(i) Rationalization of exchange rate policy.

(ii) Liberalization of imports.

(iii) Incentive to exporters.

(iv) Simplification of procedural formalities and fostering of transparency.

Economic reforms were mainly the result of crisis of 1991 which originated in the external sector of the economy. The crises, though located in the external sector were the result of several imbalances in the economy which had been built into the system over the past many years. To set them right, measures to stabilize the economy as also to reform it were initiated alongside short term steps to meet the crisis. These measures enshrined in the new economic policy, were meant to put the economy along the lines of market economies. In a nutshell since July 1991, when rupee was devalued the Government of India has announced several new policies under the name of New Economic Reforms. These reforms give a market orientation to the economy which has so far been a much controlled and a much planned economy. Although economic reforms were introduced under Rajiv Gandhi regime, they did not yield the desired result. In the end of June 1991, country landed in an unprecedented economic crisis. Reserves of foreign exchange were just sufficient to pay for two week imports. New loans were not available. Balance of payments situation of prominent sectors was leading towards crisis. Faith of international community in India economy was shaken. In order to pull the economy out of economic crisis and to put it on the path to rapid and steady economic growth, it was most essential to correct the adverse balance of payment and replenish foreign exchange reserves. To achieve all these objectives introduction of economic reforms especially in external sector was considered inevitable.

In March 1992, partial convertibility of the rupee was introduced through a dual exchange rate system known as the Liberalized Exchange Rate Management System (LERMS). Under this system 40 percent of the current receipts were required to be surrendered to the Reserve Bank at the official exchange rate while the rest sixty percent were converted at the
market exchange rate (Pattnaik, Kapur and Dhal, 2003). In March 1993, rupee was made fully convertible on trade account with the introduction of unified market determined exchange rate system. By August 1994, the rupee was made fully convertible on current account. Liberalization of imports was considered as pre-requisite for expansion of exports. Efforts have also been made to strengthen the channel of exports and ensure transparency and simplification of procedures over the past two decades to create an environment for expansion of exports. The important measures affecting foreign trade during the past two decades are briefly listed in the following table 1.3

**TABLE 1.3**

**MAJOR MEASURES TO PROMOTE INDIA'S FOREIGN TRADE SINCE 1991**

<table>
<thead>
<tr>
<th>PERIOD</th>
<th>POLICY MEASURES</th>
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<tr>
<td>1990-1991</td>
<td>i) New Export –Import policy was formulated.</td>
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<tr>
<td></td>
<td>ii) Services exports were encouraged.</td>
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<td></td>
<td>iii) Replenishment rates were modified to encourage higher value added products.</td>
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<td>1992-1993</td>
<td>i) EXIM policy for five years 1992-1997 was implemented.</td>
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<td></td>
<td>ii) Since 1992 imports were regulated through a limited negative list.</td>
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<tr>
<td>1994-1995</td>
<td>Under the Duty Exemption Scheme and the Export Promotion of Capital Goods scheme third party exports were given benefits.</td>
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<tr>
<td>1995-1996</td>
<td>i) Quantitative restrictions were phased out in the form of licensing and other discretionary controls.</td>
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<tr>
<td></td>
<td>ii) More than 3000 tariff lines covering raw materials, intermediates and capital goods were freed of import licensing requirements.</td>
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<tr>
<td></td>
<td>iii) Controls on imports were liberalized with only small list of items in negative list.</td>
</tr>
<tr>
<td>Year</td>
<td>Event</td>
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<td>----------</td>
<td>----------------------------------------------------------------------</td>
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</table>
| 1998-1999| i) In wake of the adverse impact of Asian crisis on India's exports, various measures were announced in August and September 1998, such as:  
   a) Exports under all export promotion schemes were exempted from Special Additional Duty.  
   b) Simplification of bond-furnishing procedures for exporters.  
   c) Tax holiday to EOU/EPZ for 10 years, etc. |
| 1999-2000| i) Import of 894 items was made license free and another 414 items were allowed to be imported against Special Import License.  
   ii) Free Trade Zones replaced Export Processing Zones.  
   iii) Green card for exporters exporting 50% of their production.  
   iv) Duty free imports of consumables up to certain limits for gems and jewellery, handicrafts and leather sectors.  
   v) Golden status certificates for Export and Trading Houses. |
| 2001-2002| i) Quantitative restrictions removed from 714 tariff lines.  
   ii) Setting up of Special Economic Zones. |
| 2002-2003| Agricultural Exports Promoted                                        |
| 2006-2007| Efforts were made to make India hub of gems and jewellery by accelerating their exports. |
| 2008-2009| i) Continued emphasis on Special Economic Zones.  
   ii) Exports duty on Iron ore fines was eliminated |
| 2010-2011| i) 27 new markets added under the Focus Market Scheme (FMS) with incentive of duty credit scrip at 3% of exports.  
   ii) The Zero duty Export Promotion Capital Goods Scheme and Status Holder Incentive Scrip Scheme introduced in 2009 for limited sectors and valid only for two years initially, extended by one more year till 31 March, 2012 and the benefit of scheme expanded to other sectors. |

Source: Economic Survey, Govt. of India (Various Issues)
1.3 TRADE REFORMS IN MALAYSIAN ECONOMY

Among all of the developing countries in the world, Malaysia is often held up as one of the few countries whose economic policies might be worth emulating. Notwithstanding the massive economic contraction experienced during 1997-98 financial crisis, Malaysia's economic performance has been impressive throughout the post-independence period. Sustained high growth has been accompanied by the rising living standards with a relatively equal distribution of income. This dramatic economic transformation has been underpinned by a long-standing commitment to maintaining a remarkably open trade policy regime. Historically, trade and investment barriers in Malaysia have been low in relation to other countries in region except Hong Kong and Singapore. But policy decisions enabled Malaysian economy to respond successfully to opportunities arising from increasing internationalization of production and world trade expansion. These policy decisions have in the aggregate maintained an open, liberal economy in which existing economic assets have been successfully restructured and reallocated into new combinations of labor, capital and technology in ways that it facilitated FDI-led growth. Malaysia adopted economic reforms in the mid-1960s. The process was initiated by liberalizing its international trade. The financial liberalization and capital account liberalization were initiated during the late 1970s, although country occasionally imposed controls on free market operations. Over the time, Malaysia achieved an acceptable level of economic liberalization as well as higher living standard. The key phases of Malaysia's trade policy, and its evolution over time, can be summarized in four phases:

**Phase I (1950-70):** Adoption of import substitution strategy.

**Phase II (1970-80):** Introduction of export oriented industrialization, establishment of FTZs etc.

**Phase III (1980-85):** Introduction of second round of import-substitution measures for heavy industries, such as for the automobiles, Iron and steel etc.

Malaysia continues to be a part of contemporary globalization but pattern of production and trade at the beginning of 21st century have changed radically. The production of technologically advanced and high tech manufacturers as well as of services has superseded the dominance of agricultural commodities in Malaysia’s export trade. And the benign neglect of human development that characterized the colonial era has been replaced by a concerted government policy of development, equity and empowerment for all the communities of the country’s diverse population.

Policy Trends:

Immediately after independence, Malaysia began aggressively pursuing an import substitution industrialization strategy to supplement its already-vibrant commodity export industries. In 1957 the government enacted the Pioneer Industrial Ordinance, which provided investment incentives for labor-intensive manufacturing for the domestic market. At the same time the government imposed import tariffs to protect these nascent industries. The combination resulted in brisk, although uneven, economic growth throughout the post independence decade (Narayanan 1996). Significant strides were also made in technological upgrading within several primary commodity industries, notably rubber and palm oil. The industrialization strategy of Malaysian government at the time was largely a promotional effort, geared to provision of investment climate favorable to private enterprise.

Following the communal riots, the government launched the New Economic Policy (NEP) in 1971. The NEP attempted to radically restructure society through economic policy in two ways. Its first objective was to eliminate poverty regardless of race. The second was to eliminate the identification of race with economic and social class. These objectives were to be achieved through a wide range of direct redistribution polices
including privileged access to subsidized credits, modern sector employment and share ownership in private enterprises for native Malays (bhumi\-putra). However, the resource cost of these direct redistribution policies was not a major drag on growth because the government continued to maintain an outward-oriented overall policy stance.

The government restructured industry ownership in two ways. First, it established large public enterprises protected from outside competition through tariffs. Initially most of these enterprises were fiduciably investment trusts representing “Malay (especially rural) interests.” Second, in 1975, it passed the Industrial Coordination Act (ICA), which required companies larger than 250,000 RM in paid up capital to register with the government for industrial licenses, distribute 30% of their assets to Malays (bhumi\-putra) interests, and assume a similar proportion of Malays managers. This did not mean that MNCs were immune to the NEP’s redistributive reach. Although NEP capital redistribution requirements did not apply to foreign MNCs but in case of labor quotas it applies, since foreign firms were most likely to employ Malay workers outside of the plantations. Moreover, efforts were made to dispossess and weaken foreign capital (through legal means) in labor-poor primary commodity and service sectors while simultaneously efforts were made to enhance foreign investment in labor-intensive, export-manufacturing industries.

These policies led to tremendous economic growth throughout the 1970s, driven by foreign investment and development in primary and labor-intensive manufacturing commodities. Growth however, led to little indigenous heavy industry or higher technology manufacturing. Moreover, prioritizing growth and investment through foreign MNCs and government-owned investment trusts kept the Malay entrepreneurial class small. To both deepen the industrial structure and extend the economic role of Malays into high value industries, a dynamic young minister of trade and industry, Dr. Mahathir Mohammad, formed HICOM, a series of heavy and chemical firms in sectors such as steel, cement, automobiles, chemicals, and paper and pulp.
A combination of Mahathir's extreme pro-Malay position and his nationalist "Look East" policy propelled an interventionist economic strategy that increasingly ignored market forces. The effort was not cheap, and was supported with a combination of government subsidies and increasing tariff protection, underwritten by rising income from petroleum sales. HICOM was designed to drive growth by facilitating forward and backward industrial linkages and expanding the capital goods sector. From a political perspective it strengthened economic nationalism by expanding the base of ethnic Malay entrepreneurs into investment intensive industries. But unlike many mercantilist strategies, HICOM was also a pragmatic partnership with foreign—usually Japanese or Korean—firms.

The interplay of international economic crisis of the late 1970s and early 1980s, stagnating foreign capital flows, growing reliance on foreign MNCs, and HICOM'S growing financial problems created pressures for multi-dimensional reform in trade, investment, and finance. To encourage new forms of investment capital, the government radically liberalized and deregulated trade for the export sector, reducing local ownership and content requirements and providing calculated initiatives to woo increased foreign investment, especially in manufacturing. The government began a systematic privatization of state-owned enterprises (or at least portions of them) and reduced capital controls and redirected government spending. All of these changes implicitly or explicitly relaxed application of NEP, especially for foreign investors in sum, the NEP's odd combination of redistributive, liberal, and nationalist economic policies intensified Malaysia's dualistic economy but also balanced the interests of rural Malays, foreign capital, and large Chinese capital through rapid overall growth.

**Reform, FDI, and Structural Change**

The deepening financial and capital crisis of the early 1980s further bifurcated the Malaysian economy. A combination of dwindling foreign loans and the sudden expansion of available investment capital due to the Plaza Accord yen revaluation pressured the government to intensify earlier
reform to encourage FDI. Virtually overnight the government relaxed all restrictions on capital flows and ownership that might impede the inflow of FDI, resulting in a tremendous upsurge of incoming FDI into Malaysia. Yet although growing FDI shifted coalitional priorities and generated dramatic social and economic transformation, entrenched institutional legacies and coalitional preferences impeded more comprehensive economic reform. Encourage FDI was initially designed to generate employment to relieve recessional pressures spawned by global financial downturns. But as FDI grew rapidly, priorities changed. In 1992 Mahathir unveiled “vision 2020,” a plan to transition Malaysia into a developed economy by the year 2020. In addition to growth, innovation and technological development were now needed to create the capacity for sustainable, long-term upgrading. The challenge, however, is much heavier demands on coalitions, especially on participation in comparison to structural change and upgrading places. Thus, how coalitional actors participated in economic reform began to be as important as who participated. The problem was that while existing institutions effectively created broad, passive coalitional support, they had little capacity to facilitate intensive and active participation from these same and other groups when it became needed to accomplish more complex tasks associated with upgrading.

By the mid 1980s, the Malaysian government had become fully committed to a strategy of development based on MNC-led export-oriented manufacturing. The change itself was less remarkable than its extent. Virtually every country in Southeast Asia underwent significant transformation during this period from commodity (primarily agricultural) production to embracing FDI and manufactured exports. But no country has been more successful in attracting FDI into higher technology manufactured exports, especially electronics, except perhaps Singapore. Certainly among the ASEAN-4 “Malaysia was the most active...in reshaping its investment regime to capitalize on the regional boom in manufacturing FDI during the 80s and 90s. Many of the new policy initiatives built on earlier investment liberalization. In 1986 the government restructured the investment regime by
all but eliminating the application of NEP or ICA requirements for any company exporting the bulk of its production as well as for domestic firms with less than RM 1 million shareholder capital. In the same year the Malaysian Industrial Development Authority (MIDA) was overhauled as a one-stop investment shop where new and potential investors could go to resolve all of their problems and concerns. A new industrial master plan was written with exports at its strategic center. The tax code was liberalized and rewritten. But perhaps most important, in July 1985 the government significantly liberalized ownership restrictions, and not just for firms exporting all of their production, but also for those producing for the local market. Growth continued unabated, averaging over 6.4% between 1980 and 1992. By 1991, however, growth had created labor shortages, full employment being reached in 1993. Tight labor markets put upward pressure on wages disproportionate to the historical rise in productivity. Recognizing the threat of pricing themselves out of the global market, the Government replaced the NEP with the New Development Policy (NDP) in an effort to shift out of labor-intensive to more capital- and technology-intensive manufacturing. Although the NDP retained many of the same components of the NEP, it made the application of the requirements more flexible and contingent on performance, particularly in export manufacturing. Put another way, the redistributive priorities of the NEP gave way to more developmental priorities under the NDP, which included efforts (albeit with differing emphasis) 1) increase the labor supply, 2) boost the level of skills in the local work force, 3) advance the level of technology in both foreign and domestic firms, and 4) increase the amount of local content in foreign-owned export manufacturing.

NDP reforms were difficult to implement for at least five reasons. First, economic reforms to create technological capacity take time to bear fruit. Second, whereas actors targeted to receive the benefits can easily appropriate investment incentives and spending policies, the same is not true for skills creation and research and development (R&D). Newly trained employee easily leave for rival firms and the profits from new discoveries
are often dissipated through the market before initial investments can be recovered, resulting in a series of potential collective dilemmas. Third, creating new resources with a comparative advantage in a technically complex global economy requires quantitative and qualitative improvements in acquiring, absorbing, and transferring information. Often the skills and knowledge needed for these tasks do not exist in the local economy. In an endogenous and paradoxical fashion, information is necessary to determine which skills and knowledge are needed; where best to obtain them; how best to teach, transfer, or create them; and how best to disseminate them throughout the local economy. These three considerations lead to a fourth challenge: the need for participation from more actors and the institutions to manage that participation. Finally, as the numbers of actors increase, so do potential distributional pressures. Lacking the ability to address these "developmental" challenges under "greenhouse" protection from the brumal global economy, Malaysia naturally adopted a "techno globalist" strategy of leveraging technological assets of foreign MNCs to propel the technological development of its local firms. Government addressed labor shortages and rising wages by liberalizing labor laws. To encourage an increase in female labor, especially in the MNC dominated electronics industry the government removed the paternalistic "night work" provisions making it easier for women to work the night shifts in the export factories of the MNCs. Yet other policies equally critical to facilitate the entrance of females into the work force, such as childcare provisions, were not addressed. To increase foreign labor the government allowed red-card holders to work in any sector of the economy without applying for work permits. Illegal immigrants were given amnesty so that their working status might be legalized. Yet these steps were in no way proportionate to demand.

Upward pressure on wages encouraged firms to begin a gradual shift away from low tech, labor-intensive industries. Ironically; however, moving from labor-intensive to more capital- and knowledge-intensive industries was hindered by a shortage of skilled labor. Therefore, in 1993 the government created the Human Resource Development Corporation (HRDC)
to facilitate firm-level training through the human resource development fund (HRDF). Efforts were also made to improve developmental linkages between foreign and local firms. In 1993 MIDA launched its Vendor Development Programme (VDP) in which more technologically advanced firms, usually foreign MNCs, were given incentives to mentor upgrading processes in local vendors, which they facilitated through guaranteed contracts, a free interchange of engineers and product specifications, loans with preferential terms from local banks, and ongoing technical assistance from public research institutes. From a small start of 7 MNCs in 1993 the program grew to 45 MNCs and 9 large Malaysian corporations, which had established mentoring relationships with 59 vendors. In 1995 the government launched the Small and Medium-Scale Industries Development Corporation (SMIDEC) to function as a point agency to coordinate all incentives and assistance for the technological development of local firms.

Continuing rapid growth and FDI expansion between 1990 and 1996 muted pressures for upgrading until the bottom fell out of the economy in late 1996 and early 1997. The twin pressures of falling GDP and stagnating technological progress led Mahathir to implement a new round of economic policy change, which, as before, was a complex combination of liberal reform and nationalist controls. Importantly, prior policies and institutions both spawned post crisis reform while limited its ultimate scope and effectiveness. Moreover, Malaysia’s post-crisis policy overhaul reflected and caused further coalitional shifts, often working against previously central coalitional constituents.

Lastly, Malaysia has been a remarkable economic success story, worthy in many ways of emulation by other developing countries. This praise, however, is not due to its unwavering commitment to liberal and open trade, investment, and finance. Instead, luck, pragmatism, initial conditions, and highly interventionist as well as reform minded government policy combined to balance ethnically motivated demands for a redistributive political economy (a recipe for economic disaster in most
other countries) with rapid economic expansion and growth. That the Malaysian government was able to respond to political imperatives and at the same time “advance Malaysia’s position in an evolving regional division of labor” through compromise and arbitration among competing interests, both foreign and domestic, attests to both state capacity and Mahathir’s individual leadership. The complex mix of liberal and illiberal economic policy measures has been driven, to a large extent, by coalitional priorities. Interventionist NEP-era policies were implemented to redistribute assets and create national industries for growth. As long as aggregate economic growth continued, these policies were supported by a broad yet shallow coalition of UMNO political elite, rural Malays, and big business. Rural Malays passively supported the regime while labor was actively suppressed and small and medium-sized businesses ignored. As global economic conditions changed in the 1980s, so did Malaysia’s coalitional structure. While communal issues still mattered, FDI and MNCs were thrust to the front of the pack. Massive structural change and growth was increasingly checkered by corruption and cronyism. The resulting economic policies and institutions limited complete liberalization and maintained at least some focus on redistributive priorities.

Institutional and policy legacies reared their heads again during and after the crisis, when the focus of economic policy shifted from macro-economic stability to technological development. Whereas the government could meet shifting coalitional priorities without compromising the underlying economic stability necessary for investment accumulation, it was unable to meet coalitional needs and also create knowledge and technological capacity. Prior policy patterns of exclusion, especially of labor and local business, now buttressed by institutional systems, acted to constrain efforts to resolve new and more complex collective dilemmas surrounding information exchange, investment appropriation, monitoring, and enforcement. The result has been an economy slow to transition from the process of exception that proves this rule is Penang, where dissimilar public-private relationships unencumbered by communal priorities and
patterns of small business and labor exclusion has been able to move beyond simple assembly. Whether Malaysia remains mired in a mediocre skill and value-added equilibrium depends critically on whether the ruling coalition can be reordered to include a broader cross-communal and cross-class set of active participants. Reform that goes beyond structural change to creating new stocks of labor and capital, primarily human skills and knowledge, will require the active participation and cooperation of government, labor, academia, SMIs, MNCs, and large local firms.

1.4 NEED OF STUDY:

In this globalised world individual countries are more influenced by changes in other countries. After the introduction of economic reforms foreign trade is playing a vital role for the growth of any economy. The present research is aimed at investigating pattern of growth of two countries namely India and Malaysia. Since both Malaysia and the India are developing countries it is important to investigate trade potential of these two countries in the international market. Thus, this study is focused on how the small Asian economies like India and Malaysia, can contribute to world development. There have been many in-depth empirical studies related to international trade; especially studies on bilateral trade relations between countries. However, to date, to the best of my knowledge there has been no study or research focusing on the comparative analysis of foreign trade of India and Malaysia. The present study is an effort to explore the impact of external trade reforms on economic growth of these two countries.

1.5 OBJECTIVES OF THE STUDY:

The major objective of the study is to make a comparative analysis of impact of trade reforms on the economic growth of India and Malaysia.

SUB-OBJECTIVES:

1. To discuss the process of trade reforms in India and Malaysia.

2. To study the composition and directional pattern of exports and imports of two countries.
3. To examine the trends in exports and imports in terms of volume, value and price Index of both the countries.

4. To test the mechanism of export-led growth in Indian and Malaysian economy.

5. To compare Foreign Trade and Economic Growth of two countries in pre-reform period and post-reform period.

1.6 RESEARCH METHODOLOGY:

The method of analysis has been mainly “descriptive analytic”. We have applied simple and multiple regression analysis for annual absolute time series data running from 1980 to 2012. However, in addition to this, other relevant econometrics techniques like Granger Causality analysis have also been applied.

(i) TREND ANALYSIS:

The trend analysis has been carried out by using the regression equation:

\[ Y = b_0 + b_1 t + U \] (1)

That is, to regress Y on time itself, where time is measured chronologically. Such a model is called, the linear trend model and the time variable ‘t’ is known as the trend time variable. If the slope coefficient in the model is positive, there is an upward trend in Y, whereas if it is negative, there is a downward trend in Y.

(ii) GROWTH ANALYSIS:

In order to calculate the growth rate the following regression equation has been used:

\[ Y_t = Y_0 (1 + r)^t \] (2.1)

Where,

\[ Y_0 = \text{the beginning value of } Y \]
\[ Y_t = Y's \text{ value at time } t \]
\[ r = \text{the compound rate of growth of} \ Y \]

Taking the natural log of above equation (2.1) on both sides we obtain:

\[ \ln Y_t = \ln Y_0 + t \ln (1 + r) \quad (2.2) \]

**Let,** \( b_0 = \ln Y_0 \quad (2.3) \)

\( b_1 = \ln (1 + r) \quad (2.4) \)

Therefore, the equation (2.2) can be written as:

\[ \ln Y_t = b_0 + b_1 t \quad (2.5) \]

Now, If we add the error term \( U \) to above equation (2.5), we obtain:

\[ \ln Y_t = b_0 + b_1 t + U \quad (2.6) \]

The above model is like any other linear regression model in that parameters \( b_0 \) and \( b_1 \) are linear. The only difference is that the dependent variable is the logarithm of \( Y \) and the independent variable or explanatory variable is 'time', which will take values of 1,2,3 etc. The above model is also called a semi-log model because only one variable (in this case the dependent variable) appears in Logarithmic form. In a semi-log model the slope co-efficient measures the proportional or relative change in \( Y \) for a given absolute change in the explanatory variable. If we multiply this relative change by 100, we obtain the percentage change or the growth rate also called instantaneous growth rate.

**INSTANTANEOUS VERSUS COMPOUND GROWTH RATE:**

We know from the equation (2.4) that

\[ b_1 = \ln (1 + r) \]

**Therefore,** \( \text{Antilog} (b_1) = (1 + r) \)

\[ r = (\text{Antilog} b_1 - 1) \]

And since \( r \) is the compound rate of growth, once we have obtained \( b_1 \) (the slope coefficient) we can easily estimate the compound rate of growth of \( Y \) by using the following formula:

**Compound Rate of Growth = (Antilog \( b_1 \) - 1) \times 100**
The instantaneous growth rate measures the growth rate at a point in time whereas compound growth rate measures the growth rate over a period of time.

(iii) LOG LINEAR MODEL:

In order to calculate the elasticity of the slope coefficient, we have used the log linear model:

\[ Y_i = A X_i^{b_1} \]  \hspace{1cm} (3.1)

The above equation can be written as:

\[ \ln Y_i = \ln A + b_1 \ln X_i \]  \hspace{1cm} (3.2)

Where, \( \ln \) = natural log, that is, logarithm to base e (where, \( e = 2.718 \) approx).

Let \( \ln A = b_0 \)

Now equation (3.2) can be written as:

\[ \ln Y_i = b_0 + b_1 \ln X_i + U_i \]  \hspace{1cm} (3.3)

For estimating purpose, the equation can be written as:

\[ \ln Y_i = b_0 + b_1 \ln X_i \]

This a linear regression model, for the parameters \( b_0 \) and \( b_1 \) enter the model linearly. This model is also linear in the logarithms of the variables Y and X, because of this linearity, the model like equation (3) are called double-log (because both variables are in log form) or log-linear (because of linearity in the logs of the variables) models.

One attractive feature of double log or log linear, model that has made it popular in empirical work is that the slope coefficient \( b_1 \) measures the elasticity of Y with respect to X, that is, the percentage changes in Y for a given (small) percentage change in X. The model further assumes that the elasticity coefficient between Y and X remains constant through-out; hence the alternative model’s name is constant elasticity model.
(iv) DUMMY VARIABLE APPROACH:

When we use a regression model involving time series data, it may happen that there is a structural change in the relationship between dependent and independent variables. Sometimes the structural change may be due to external force. It is assumed that the effect of policy reform or economic reforms might influence the India's foreign trade and economic growth from 1992 and Malaysia's foreign trade and economic growth since 1986. Structural stability test has been performed to verify whether there has been any structural change in foreign trade of India and Malaysia in Pre and Post economic reforms period. We have therefore, included dummy variable in the regression equation both in intercept and slope form. The equation can be written as:

\[ Y = b_0 + b_1 D + b_2 X + b_3 (D \cdot X) + U \]  \hspace{1cm} (4.1)

Where,

- \( Y \) = Dependent variable
- \( X \) = Independent variable
- \( D \) = Dummy variable

\[ D = 1 \text{ (For Post-Reform Period)} \]
\[ D = 0 \text{ (Otherwise i.e., for Pre-Reform Period)} \]

(Implication of regression equation (1), assuming \( E (U) = 0 \), we obtain :)

\[ E ( Y/ D=0, X) = b_0 + b_2 X \]  \hspace{1cm} (4.2)
\[ E ( Y/ D=1, X) = b_0 + b_1 + b_2 X + b_3 X \]
\[ = (b_0 + b_1) + (b_2 + b_3) X \]  \hspace{1cm} (4.3)

Which are respectively the mean functions for the pre-reform and post-reform period. Thus, from the single regression (4.1), we can obtain the two sub periods regression easily, again showing the flexibility of dummy variable technique.
Regression Equation for Pre-Reform Period:

\[ b_0 + b_2X \]

Regression Equation for Post-Reform Period:

\[(b_0 + b_1) + (b_2 + b_3)X\]

In the regression equation (4.1) \( b_1 \) is the differential intercept and \( b_3 \) is the differential slope coefficient, indicating by how much the slope coefficient of the post-reform period differs from the slope coefficient of the pre-reform period. The introduction of Dummy Variable (D) in the additive form enabled us to distinguish between the intercepts of two periods and the introduction of Dummy variable (D) in the interactive or multiplicative form (D Multiplied by the explanatory variable) enables us to differentiate between the slope coefficients of the two periods i.e. pre-reform period and post-reform period. The statistical significance of differential intercept \( b_1 \) and differential slope coefficient \( b_3 \) indicates structural changes.

(v.) AUGMENTED DICKY FULLER TEST:

The Augmented Dickey Fuller (ADF) test is preferred as most of the studies have adopted it to examine the Unit root in the series. In case of Dickey-Fuller test, there may create a problem of Autocorrelation. To tackle the problem of Autocorrelation problem, Dickey Fuller has developed a test called Augmented Dickey Fuller (ADF) test. ADF Unit Root test are based on following three models:

1. **Without Constant and Trend:**

\[ \Delta Y_t = \delta Y_{t-1} + \sum \alpha_i Y_{t-1} + \epsilon_t \]  \hspace{1cm} (5.1)

2. **With Constant (Intercept):**

\[ \Delta Y_t = \beta_1 + \delta Y_{t-1} + \sum \alpha_i Y_{t-1} + \epsilon_t \] \hspace{1cm} (5.2)

3. **With Constant and Trend:**

\[ \Delta Y_t = \beta_1 + \beta_2 t + \delta Y_{t-1} + \sum \alpha_i Y_{t-1} + \epsilon_t \] \hspace{1cm} (5.3)
Null Hypothesis $\Rightarrow H_0: \delta = 0$ (Series is not stationary or got unit root)

Alternative Hypothesis $\Rightarrow H_1: \delta \neq 0$ (Series is stationary or no unit root problem). If the computed absolute value of the tau statistics ($\tau$) exceeds the ADF or Mackinnon critical values, we reject the hypothesis that $\delta = 0$, in which case the time series is stationary. On the other hand, if computed absolute value of the tau statistics ($\tau$) does not exceed the critical tau value, we do not reject the null hypothesis, in which case the time series is non-stationary.

(vi) **GRANGER – CAUSALITY TEST:**

This test is based on the Granger (1969) approach to the question of whether $X$ causes $Y$. Granger proposed to know how much of the current value of $Y$ can be explained by the past values of $Y$ and then to find out whether adding lagged values of $X$ can improve the explanation. The direction of causality determines the direction of the relationship among variables and Granger causality test has three different directions for these purposes such as: If in a single equation model, $Y$ is the dependent variable and $X$ independent. Here, there is a causality relationship from $X$ towards $Y$ ($X \rightarrow Y$). Independent variable is the cause and causes a one-way effect on dependent variable, which shows the presence of one-way causality and the relationship is determined as ($Y \rightarrow X$). There can be also a reciprocal effect between the variables and no causality means that there is no relationship among variables.

Granger’s causality test is carried out by using the following equations:

$$ Y_t = \sum_{i=1}^{m} \alpha_i Y_{t-1} + \sum_{j=1}^{m} \beta_j X_{t-j} + u_{1t} \quad (6.1) $$

$$ X_t = \sum_{i=1}^{m} \lambda_i X_{t-1} + \sum_{j=1}^{m} \delta_j Y_{t-j} + u_{2t} \quad (6.2) $$

The above equation (6.1) shows a causality relationship from $X$ to $Y$, 

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and the equation (6.2) from Y to X. For the model presented above, Granger causality test is carried out as $H_0: \beta = 0$ and $H_1: \beta \neq 0$. When $H_0$ hypothesis is accepted, X is not the cause of Y. If $H_1$ hypothesis is accepted X is the cause of Y. If both hypotheses are rejected, this means there is a two-way causality between X and Y.

1.7 SOURCES OF DATA:


1.8 LIMITATIONS OF THE STUDY:

1.) The Study is open to all the limitations of econometrics techniques which are used in present study.

2.) While determining the regression equations, the imports and exports are taken as the dependent variable and time period as the independent variable all other factors are considered to be constant.

3.) The Study has included only merchandise exports and imports and has excluded the exports and imports of services so our study is limited to merchandise trade only.
1.9 CHAPTER PLAN OF THE STUDY:

The present study has been divided into seven chapters, which are as follows:

Chapter- I - Introduction

Chapter- II - Review of Literature

Chapter- III - India’s Foreign Trade: Composition & Direction (1980-2012)

Chapter- IV - Malaysia’s Foreign Trade: Composition & Direction (1980-2012)

Chapter- V - Trade Pattern of India and Malaysia: A comparative Study (1980-2012)

Chapter- VI - Impact of External Sector Reforms on Economic Growth of India and Malaysia (1980-2012)

Chapter-VII - Conclusions and Policy Implications