CHAPTER - II

REVIEW OF LITERATURE
CHAPTER II
REVIEW OF LITERATURE

2.1 INTRODUCTION:

International trade assumes a great significance in the economic development of both developed and developing countries. As the process of globalization of economies gathers momentum foreign trade becomes one of the major important components of economic growth. International trade not only involves the flow of goods and services across the countries, but also the factors of production, labor and capital. It facilitates an efficient allocation of resources across countries generally leading to greater specialization of output as well as accelerated economic growth. It offers countries a potentially powerful mechanism to achieve a higher, stable and steadily increasing standard of living than would otherwise be feasible, allowing them to exploit opportunities beyond their own geographical boundaries.

Theoretically, as well as empirically divergent views are held on the relationship between foreign trade and economic growth. Some researchers find that international trade stimulates economic growth whereas others have found evidences contrary to this view. The existing literature gives no definite answer to the question; what is the relationship between foreign trade and economic growth? The theory offers three different views on the relationship between trade and development- a positive, a negative and an eclectic view. The positive view has been held by classical and neo-classical economists. According to them foreign trade is an "engine of economic growth". On the other hand, structuralists believe that international trade has actually operated to the detriment of the poor countries causing deterioration in their terms of trade. In between these two extreme positions, lies an eclectic view which incorporates some elements of each of the opposing viewpoints. According to this view exports can act as a stimulus to the rest of economy under favorable conditions.
2.2 THEORETICAL ELABORATION:

Many theoretical studies have been undertaken to assess the role of foreign trade in economic growth of a country. It would be very difficult to discuss all the studies here, therefore, few of them are as follows:

Adam Smith’s (1776)\(^1\) model of foreign trade postulates the existence of idle land and labor before a country is opened to world markets. The excess resources are used to produce a surplus of goods for export and, trade thereby ‘vents’ a surplus productive capacity that would otherwise be unused. The idea of ‘vent for surplus’ assumes that resources are not fully employed prior to trade, and that exports are increased without a decrease in domestic production, with the result that raises the level of economic activity. As far as the interaction between international trade and economic growth is concerned, we found two main ideas to point out in Smith. On the one hand, international trade made it possible to overcome the reduced dimensions of internal market and, on the other hand, by increasing the extension of the market, the labor division improved and productivity increased.

Ricardo (1817)\(^2\) demonstrated that under the conditions of free trade, a country will specialize in the production and export of those commodities for which its costs are comparatively lowest, and will import commodities it can produce only at high relative cost. In following its comparative advantage, each country maximizes output per unit of input. The welfare result according to Ricardo is that “the extension of foreign trade---------will very powerfully contribute to increase the mass of commodities, and therefore, the sum of enjoyment”.

Mill (1848)\(^3\) stated that trade, according to comparative advantage, results in a ‘more efficient employment of the productive resources of the world’, and that this might be considered the “direct economical advantage of foreign trade. But there are, besides indirect benefits, which must be counted as the benefits of high order”. A most important benefit, according to Mill, is widening the extent of the market including innovations and
increasing productivity through foreign trade which allows a country to overcome the diseconomies of being a small country.

Haberler (1959)⁴ quote: ‘what is good for promoting the national income and standard of living is at least potentially also good for economic development, for the greater volume of output, the greater can be rate of growth provided the people individually or collectively have the urge to save and to invest and to develop economically’. The higher is the level of output, the easier is to escape the vicious circle of poverty and take-off into “self-sustained growth”. Hence if trade raises the level of income, it promotes economic development.

Corden (1971)⁵ has listed five possible supply side benefits of trade in the process of economic growth of a country. These are:

1. The GDP growth due to gains from international trade.
2. Capital accumulation effect due to increased profitability of investment and part of additional GDP going to savings.
3. Substitution effect reflected in a fall in the cost of capital due to increased investment.
4. Income distribution effect reflected through shifts in favor of trade sector and
5. Factor weight effect reflecting factor rise in factor productivity, initially in the trade sector but consequently getting diffused throughout the economy. These effects all are cumulative and intensify the increase in real income over time as a result of opening a country to foreign trade.

The growth effects of trade openness are made more explicit by the use of the new growth theory led by Romer (1986)⁶ and Lucas (1988)⁷. Within such framework, Grossman and Helpman (1991)⁸ establish that trade openness enhances economic growth through following channels:

1. Trade enlarges the available variety of intermediate goods and capital equipment, which can expand the productivity of the country’s other resources.
2. Trade permits developing countries the access to improved technology in developed countries, in the form of embodied capital goods.

3. Trade allows intensification of capacity utilization that increases products produced and consumed.

4. Openness offers a larger market for domestic producers, allowing them, on one hand, to operate at minimum required scale, and on the other hand, to reap benefits from increasing returns to scale.

Skepticism about the effect of trade openness on income is based essentially on two premises, as put forward by Prebisch (1950) and Singer (1950). First, incessant decrease in the international price of raw materials and primary commodities would lead, without industrialization in developing countries, to more profound differences between developed and developing countries. Second, for their industrialization, developing economies require short or medium term protection of their infant industries. Furthermore, the structure of trade, under which exports are concentrated on a few primary products and imports are constituted mostly by manufactured goods, renders developing countries overly dependent and vulnerable. Due to the low price elasticity of developing countries' export products and the fact that demand for primary products is rather contained in international market, these small economies face continuously deteriorating terms of trade.

2.3 EMPIRICAL INVESTIGATION AT INTERNATIONAL LEVEL:

The relationship between trade openness and economic growth has been the subject for many studies and research projects. Opening up the economy is supported by many people since in their opinion, it helps to enhance the technical development and increase the efficiency of industry and service sectors (Jayanthakumaran, 2002). Various empirical studies both cross-section and time series have been undertaken to assess the impact of trade reforms on economic growth at the international level which are as follows:
Emery (1967) on the basis of his cross sectional study using the regression analysis of 1953-63 for 50 countries concluded that “countries eager to increase their growth rates should adopt the type of policies that will stimulate exports”. He found a strong relation between average rate of growth of GNP, per capita real GNP and of earnings of current account. He analyzed that a country can increase its per capita GNP by 1 percent for 2.5 percent increase in its exports. Emery obtained the following regression equation:

\[ \text{Per Capita Real GNP} = 0.20 + 0.4096X \]

Where, X=Exports

This equation implies that for each 1 percent rise in exports, GNP increases 0.4 percent.

Michaely (1977) found both GNP and exports as positively correlated to the extent of 0.380 when he studied 41 LDCs for the period 1950-73. His study was based on 1972 per capita income of $300 as the benchmark dividing the third world countries into more developed and less-developed. He concluded that a correlation of 0.523 exists in case of relatively rich countries, compared with a rank correlation of (-0.04) in case of poor countries, which suggests that growth is affected by export performance when a country achieves some minimum level of development.

Balassa (1978) considered a sample of 11 LDCs with different grades of use of strategies of promotion of exports and substitution of imports for the period 1960-73 and stressed, on one hand the significance of the export growth and on the other hand that countries with rates of export growth higher than the average also registered best performances.

Feder (1982) provides a clear analytical basis for a systematic and empirical study on the relationship between exports and economic growth. The analytical part of the study explains two ways by which exports influence growth. First, through positive externalities of the export sector on the non-export sector. Secondly, through greater productivity differential, as
compared to the non-export sector. These relationships are empirically tested, using linear regression estimations, for a cross-country data of 31 countries. The empirical evidence provides support for both the relationships tested, although the evidence for the second relationship is shown to be stronger than the first relationship.

Sanjeev Gupta (1985)\(^{13}\) examined empirically the relation between exports and economic growth during the period 1960-80 for two countries namely Israel and South Korea. The empirical results indicate that the relationship between export growth and economic growth is bi-directional in nature for both the countries. This observed two way causality is consistent with a type of scenario where export promotion by efficiently allocating resources according to comparative advantage causes economic growth, which in turn interacts with a scenario where external economies associated with the economic growth like technological progress, quality of labor force, development of institution and infrastructure influence export growth.

Esfahani (1991)\(^{14}\) examined inter-relationship between exports, imports and output growth in a simultaneous equation model. He specially examined the consequence of adding imports to the list of input requirements for production because of a binding foreign exchange constraint. Using the data set comprising of a sample of 31 countries the study clearly shows the positive impact of exports on GDP due to import reduction rather than the Feder's type externality effect.

Lee (1995)\(^{15}\) used cross section data from 89 countries to investigate the impact of capital goods imports on the per capita growth between 1960-85. Lee showed that the countries with a higher ratio of capital goods import to investment grow faster in terms of GDP per capita, when the overall ratios of investment to GDP and total imports to GDP are taken into account.

Sinha and Sinha (1996)\(^{16}\) hold that trade liberalization; mainly export-promotion is an important contributor to the economic growth of a nation, especially in developing nations. They paid more attention to cross-section and time-series studies of trade balance, to illustrate export-led
growth. They found a positive relationship between the degree of openness and growth rate of 29 Asian countries between 1951 and 1990.

**Emmanuel and Ahmad (2000)** analyzed the causal relationship between economic growth and openness for the selected ASEAN countries (Indonesia, Thailand, Malaysia, Philippines, and Singapore) during the period 1960-1997. The study employs the Johansen’s co-integration technique for testing the rank of co-integration space spanned by the stochastic process of economic growth and openness. The study proves that economic growth and openness are co-integrated for all the countries under study. Lastly, the findings of study support both the openness driven economic growth and economic growth-led openness hypothesis.

**Vohra (2001)** showed the relationship between the exports and growth in India, Pakistan, Philippines, Malaysia and Thailand for the period 1973-1993. The empirical results indicated that when a country has achieved some level of economic development then the exports have a positive and significant impact on economic growth.

**Santos and Thirlwall (2004)** analyzed the impact of trade liberalization on export growth, the balance of trade, and balance of payment using panel data from 22 developing countries for the period 1972-1997. These countries began liberalization in the mid 1970s. The results found that while exports grew at 2 percent per annum, leading to a deterioration of trade balance of at least 2 percent of GDP. And it has shown the remarkably better performance of liberalizing nations during the last three decades as compared to non-liberalizing nations.

**Pazim (2009)** tested the validity of the export-led growth hypothesis in the BIMP-EAGA countries (i.e. Indonesia, Malaysia and the Philippines) using panel data analysis. The panel co-integration test indicated that there was no co-integrating relationship between exports and development for these countries. As a conclusion, exports could not be seen as the “engine” of growth in these countries. In other words, empirical findings did not provide sufficient evidence to support the export-led hypothesis in these countries.
2.4 EMPIRICAL INVESTIGATION IN INDIAN CONTEXT:

Various empirical studies regarding the impact of trade reforms on economic growth in case of India are as follows:

Attri (1980)\textsuperscript{21} statistically analyzed the relationship between foreign trade and economic growth in India since 1947. He followed case study approach and applied least square regression technique. The statistical analysis shows that there exists a very close relationship between exports and economic growth. The study also indicates that India’s capacity to import improved during the period 1947-77 and this improvement was greatly enhanced because of the export-promotion schemes adopted by the Government of India during the third five year plan and devaluation of rupee in June, 1966.

Nandi and Biswas (1991)\textsuperscript{22} investigated the empirical relation between Indian exports and economic growth, using data for the period 1960-1985. The study proves that exports can promote economic growth by increasing aggregate demand. In the Indian context, econometric results show that export growth causes growth of national income and also overall economic development.

Rashid (1995)\textsuperscript{23} developed an empirical model by using the dummy exogenous variable technique to capture the impact of economic liberalization during 1977-89. The model estimates the determinants of growth, industrial output, investment and trade by using multiple equation model and the interrelationship between these variables is tested using simultaneous equation model. The estimated results offer evidence for the hypothesis that liberalization, by reducing controls and regulations and adopting more outward orientation leads to a more efficient utilization of resources and higher levels of growth.

Mallick (1996)\textsuperscript{24} investigated empirical evidence with reference to India to establish the causation between exports and economic growth over the period 1950-51 to 1991-92 using co-integration based on Error Correction Model (ECM). The study explains that the expansion of
productive capacity through income growth can raise exports, and increased probability of exports can induce increased savings and thereby capital accumulation, which give rise to economic growth.

Ghatak and Price (1997)\textsuperscript{25} examined the Export-Led-Growth (ELG) hypothesis in case of India for the period 1960-1992. The empirical results indicate that real (aggregate) export growth is Granger-caused by non-export real GDP growth in India over 1960-92. Their co-integration tests confirm the long-run nature of this relationship. However, imports do not appear to be important in the case of Indian economy.

Mehta (1997)\textsuperscript{26} attempts to analyze the impact of India’s recent trade policy reforms on external trade. He used Indices of trade liberalization like the Effective rate of protection (ERP) and the Nominal rate of protection (NRP) to quantify the extent of protection granted to the Indian industry. He also used index of structural change and the Sign test to analyze the composition of India’s exports and imports. The findings of the study show a decline in the level of protection given to the Indian industry as measured by ERP, though there has been no statistically significant change in India’s composition of exports and imports between pre-Liberalization and post-liberalization period.

Dhawan and Biswal (1999)\textsuperscript{27} investigated the Export-Led-Growth hypothesis using a Vector Auto Regressive (VAR) model by considering the relationship between real GDP, real exports and terms of trade for India 1961-93. They employed a multivariate framework using Johansen’s co-integration procedure. They find long-run equilibrium relationship between the three variables and the causal relationship flows from the growth in GDP and terms of trade to growth in exports. However, they conclude that causality from exports to GDP appears to be a short-run phenomenon.

Kaushik and Paras (2000)\textsuperscript{28} statistically analyzed the relationship between trade liberalization and export performance in Indian economy. Their study examines growth, variability of exports, sources of export variability and the impact of export instability on economic growth. They
estimated exponential growth rates, instability and variability in logarithms to access the relative importance of price and quantity fluctuations for the period 1984-85 to 1997-98. The study reveals the following facts: Exports of Indian agriculture and allied products, and manufactured goods have increased significantly since the initiation of trade liberalization, Instability in export earnings is mainly due to volume instability rather than the price variability, and Export instability showed a negative and statistically significant impact on the economic performance of the economy.

Nidugala (2000) analyzed the role of exports in India's economic growth by employing a modified version of Esfahani's study (1991). He examined the stability of the relationship between exports and growth through switching regression in Indian context. An attempt is also made to test whether the monetary and fiscal factors, structure of the economy and supply shocks both domestic and external, have any significant impact on India's economic growth during the period 1960-80. The study shows that exports play a crucial role in influencing GDP in the 1980's. However, during the period 1961-62 to 1979-80, the influence of exports is found to be weak. There is also evidence of a positive relationship between exports and growth in 1980’s due to higher level of development and change in the composition of exports in favor of manufactured exports by Indian economy.

Abhijit and Panagiotidis (2003) tested the Export-Led-Growth hypothesis in case of India during the period 1971-2000 by using Granger causality tests. The empirical results indicates that relatively 'big shocks' in real exports do not generate significant responses. This strengthens the argument against the ELG hypothesis in case of India and strengthens the argument that in spite of reforms, it still retains some characteristic of an import-substituting economy.

Dutta and Ahmed (2004) investigated the behavior of Indian aggregate imports during the period 1971-1995. According to his econometric estimates of the import-demand function for India, import-demand is largely explained by real GDP.
Sudhakar and Kurien (2005)\textsuperscript{32} statistically analyzed the relationship between exports and economic growth in India over the pre-liberalization period 1960-92, using stationarity, co-integration and Granger causality tests. The analysis is conducted within a rigorous econometric framework that accounts for optimal lag selection and simultaneity bias. They also used Seemingly Unrelated Regression (SUR) procedure to account for possible simultaneity bias between exports and economic growth. The study found strong evidence for unidirectional causality running from exports to economic growth.

Batra and Khan (2005)\textsuperscript{33} used RCA, at both the sector and product level, to identify the pattern of RCA for India and China. By using Balassa's (1965) index for the two and six digit level of Harmonized System (HS) classification, the study finds that the pattern of comparative advantage varies at different levels of commodity disaggregation. In analyzing comparative advantage according to factor intensity, the study shows large similarities in the structure of comparative advantage for India and China. Both, India and China enjoy comparative advantage for labour and resource intensive sectors in the global market. However, no evidence is found on the structural shift for the manufacturing sector as a whole for both countries except for sectors within manufacturing.

Chandra Sekhar and Nirmal Chandra (2007)\textsuperscript{34} analyzed the impact of Indian merchandise trade sector on the overall economic performance for the period 1991-2005 and also examined how liberalization has influenced the trade structure of country. They estimated compound annual growth rates and applied OLS method for this purpose. The econometric analysis has shown that both exports and imports have a positive impact on the economic growth of country. In addition, exports have a larger impact than imports on economic growth. So the famous economic postulate that 'Foreign trade is an engine of economic growth' is being reiterated in case of Indian economy.

Sarbapriya Ray (2011)\textsuperscript{35} analyzed the empirical relation between foreign trade and economic growth in case of India over the period 1972-73.
to 2010-11 by using Granger-causality test. The empirical findings of the study confirmed the presence of bi-directional causality which runs from economic growth to foreign trade and vice-versa.

2.5 EMPIRICAL INVESTIGATION IN MALAYSIAN CONTEXT:

Various empirical studies regarding the impact of trade reforms on economic growth in case of Malaysia are as follows:

Riezman et al. (1996)\(^{36}\) examined validity of the export-led growth hypothesis for 126 countries' annual data running from 1965 to 1999. They conducted three types of co-integration procedures, namely: bivariate, trivariate and 5-variable models. The variables selected are GDP, export growth, real import growth, primary school enrollment (as % of primary school age children) and the ratio of total investment over output. The authors reported that there was no short-run causal effect in the bivariate and five-variable causality tests in the Malaysian case. Hence, they concluded that the hypothesis of export-led growth does not hold in the case of Malaysia.

Abdul Rahman (1997)\(^{37}\) analyzed bilateral trade between Malaysia and Japan using input-output tables. The study reveals Japan exports manufactured goods to Malaysia which Malaysia cannot produce and imports raw materials which it does not possess. The value of Japan’s exports to Malaysia is higher than imports and Japan’s industries have insignificant impact by Malaysia’s final demand. But Malaysia’s industries especially forestry and logging, crude petroleum and metal mining are highly dependent on Japan’s demand structure.

Ghatak et al. (1997)\(^{38}\) examined foreign trade and economic growth of Malaysia and conclude that exports have played a substantial role in promoting economic growth of Malaysia by earning foreign exchange and achieving economies of scale. The direction of exports was the same for the past two decades. The United States, Singapore and Japan were the main importers of exports of Malaysia.
Yousif (1999) examined the relation between exports and economic growth in the Malaysian context. He examined the validity of the ELGH by considering a multivariate analysis, including variables such as the exchange rate, labor and capital. The empirical results of the study confirms the viability of export-led growth as a short run phenomenon in Malaysia.

Siddique et al. (1999) studied the relationship between economic growth, total exports and manufactured exports in Malaysia using co integration and Granger Causality test. The results of Granger Causality did not produce any evidence to support the ELGH in Malaysia for both total exports and manufactured exports. However, evidence of a one way Granger Causality running from economic growth to manufactured exports was found.

Baharumshch and Rashid (1999) examines the relationship between export growth and income growth by including imports in the system of equations using the Johansen (1988) procedure and Vector-Error Correction (VEC) model and detected the presence of a stationary long-run relationship between exports, imports and GDP. The empirical findings of their study indicated that an important determinant of long-run growth in the fast growing Malaysian economy is imports of foreign technology.

Amir (2000) calculated RCA index to examine Malaysia’s export specialization pattern between 1994 and 1998. From his findings, he observes that even though the overall electronic and electrical manufacturers retained their importance in the manufacturing sector, the sliding down in the RCA index in some product groups in this category (e.g., “Office Machines” and “Radio Broadcast Receiver”) suggest that rising competition resulting from regiona-lization (AFTA) and globalization is eroding Malaysia’s strong position.

Choong et al. (2003) found that ELGH was valid in the Malaysian economy in both short-run and long-run. Their study focused on economic growth, imports, exports, imports of consumption goods, capital formation, labour force and exchange rate.
Veera Pandiyan (2003) examined the intra-industry trade of Malaysia for the period 1996-2000 using the Revealed Comparative Advantage method. And concluded that Malaysia has departed from natural resources based industries to skilled and technology intensive industry. The GL index shows that Malaysia is experiencing the intra-industry trade phenomena where export and import tend to be in same product indicating a limited role of economies of scale and product differentiation.

Nair & Madhwan (2006) studied and examined the impact of trade openness on the manufacturing sector in Malaysia Using a robust econometric formulation called the Unrestricted Error Correction Model (UECM). The study found that Malaysian manufacturing sector is labor intensive and seemed to be losing its competitiveness and there is positive impact of openness on manufacturing sector in Malaysia.

Bashar (2008) analyzed the impact of liberalization on Malaysia’s economic growth by using time series data for the period 1970-2003. He used co-integration and error correction methods and Granger causality tests. The empirical findings of the study reveals that trade liberalization have a significant positive impact on economic growth of Malaysian economy in the long-run.

Tuan Lonik (2008) attempted to analyze the export-led growth hypothesis in Malaysia for the period 1978 - 2002. The analysis used the Autoregression Distributed Lag (ARDL) model and co-integrating procedure that was first developed by Pesaran etal. (1996). He found that the hypothesis is valid in the case of Malaysia for the period under study.

Baharon & Royfaizal (2008) examined the role of trade openness and FDI in influencing economic growth in Malaysia for the period 1975-2005, using the Bounds testing approach. The empirical results demonstrated that trade openness is positively associated and statistically significant determinant of economic growth, both in short run and long-run. The results also suggested that FDI is positively associated in short-run and negatively in long-run both significantly.
Mahani and Wai (2008)\(^49\) analyzed RCA for Malaysia in selected manufacturing goods between 2001 and 2005. Their result indicates that the overall RCA index for machinery (except electrical) was slightly above 1 and showing a small indication of a falling pattern. They conclude that the share of manufacturers of machinery goods in the country's exports was slightly above the world's average. Within the subsector, Malaysia does not possess a comparative advantage in most of the product groups. RCA indices for textile, clothing, and footwear indicate that the country has no comparative advantage in these three industries. The country's export share was less than the world's average for most of the product groups. In addition, Malaysia does not have a comparative advantage for the manufacturing of metal as well.

Hussin et al. (2009)\(^50\) examined the impacts of trade openness and fiscal policy on economic growth in Malaysia between 1970 and 2003 using the Autoregressive Distributed Lag (ARDL) approach and bounds test as proposed by Pesaran et al. (2001). Based on a structure consistent with the endogenous growth theory, the ARDL results show that, overall trade openness and fiscal policy have strong positive impacts on economic growth in Malaysia over this period. This paper also develops a system instrumental variable method to estimate the structural speed of adjustment coefficient in an error correction model.

2.6 CONCLUSIONS:

From the review of literature it is apparent that although economists have written quite extensively on the subject of foreign trade and economic growth, but the above studies have examined the impact of trade reforms on economic growth of India and Malaysia individually. Most of the studies have touched the one or other aspect of trade and economic growth. No single study is available which can cover all the aspects of trade and their influence on economic growth. Moreover there have been relatively few statistical studies undertaken in the post-reform period to determine more precisely the role of foreign trade in promoting economic growth. In spite of

However, to date, best of my knowledge there has been no academic study or research focusing on the comparative analysis of foreign trade of India and Malaysia. Therefore, our study is an attempt to fill this research lag and to make a comparative analysis of trade reform process in India and Malaysia and to examine the influence of trade reforms on economic growth of two countries.
REFERENCES


20. Pazim, KH (2009), "Panel data analysis of "Export-led" growth Hypothesis in BIMP- EAGA Countries".


43. Choong, C.K, Zulkornain, Y. and Vebus K.S.L (2003), "Export-led
growth Hypothesis in Malaysia: An Application of Two-stage Least Square Technique"


