

Effects of inflation on malaysias economic growth economics essay

[Economics](#)



CHAPTER 2: LITERATURE REVIEW

2. 0Introduction

Economic growth has been the focus of the world especially after the debt crisis in year 2008. The main objective of our research is to examine the effects of inflation on Malaysia's economic growth. Before holding out our research, we did some study about previous researchers' work on the relevant topic.

2. 1Review of the Literature

Pörtner (1996) has carried out a research to analyze the relation between population and economic growth through reviewing existing literature and analysis of a basic Ramsey model (it is the most widely used benchmark model for analysing growth, savings, and consumption decisions in macroeconomics) with endogenous fertility. His used theoretical models to describe the relationship between fertility, consumption, and investment. The main idea is to study the results obtained by formal modelling of the relationships and to discuss the problems and benefits using it. From the paper, he says that the household can be seen as deriving utility from children for longer than the instant in which they are born. This is because children add to the size of the population in subsequent periods and thereby, *ceteris paribus*, increase the utility. In effect reduced altruism indicates that people care less about future generation, since there is less return to size in terms of utility, and thus corresponds to a higher effective rate of time preference. A higher epsilon also means that an increase in the birth rate does not have as strong as effect on the effective rate of time preference. On

the other hand, if the return to labour is high, then investment in people mean less room for consumption now but more in later days. Finally, there is a positive effect from the net return to capital on the growth rate. An increasing mortality rate leads to a higher birth rate and consequently to higher capital and consumption per capita. However, the effect on the birth rate is small. The results imply that there will be zero population growth for d between zero and one, probably closer to the latter. The effect on capital is quite substantial, even if higher mortality rate means lower returns to capital as indicated by the interest rate. The reason for the larger increase in capital and consumption must then be found in the large inverse capital dilution effect with high mortality rate. Even if total capital remains the same the fast deceleration in total population leads to a high amount of capital per capita. (Pörtner, 1996)Pörtner (1996) also stated that the main advantage is the bounded utility condition would become less of a problem. However, the disadvantage is that the algebra becomes even more complex and this might hamper a full explanation of the relations in the model. Finally, given that an important aspect of population growth is how it changes over time a dynamic analysis is a high priority when the model has been solved satisfactorily. He suggested that for future research programme, it can be divided into four main themes which are fertility and mortality, growth and distribution, education and labour supply and lastly, the environment. He stress that one has to keep in mind where this is still the only part of the huge area, which is population and development. On the other hand, Haroon and Nasr (2010) studied the role of private investment in economic development of Pakistan. They want to contribute to an important aspect of

the economy of Pakistan, which is, private investment and its determinants during the financial period from 1986-87 to 2007-08, and the factors which determine it. In their paper, they discussed the local environmental conditions and what should be done so that local products may have improved quality not only for local consumption but also for exports, especially for the agriculture sector in order to improve the agro industrial products providing raw material to the other sector of Industry. In order to do their investigation, they have collected data from various sources covering 22 financial years from 1986-87 to 2007-08, mainly from Federal Bureau of Statistics, State Bank of Pakistan (SBP) and Board of Investment (BOI). Meanwhile, they have used multiple regression, linear regression and correlation to analyze their data. From the result, they found that indirect taxes have a negative impact on private investment while interest rate has a weak negative impact on private investment; on the other hand, subsidies have a positive impact on private investment and GDP, Domestic savings and Government development expenditures (PSDP) got strong positive and significant results. They also found that there is a negative relationship between debt servicing and private investment. This indicates that the role of private investment in Pakistani development sector in GDP and the impact of Government development expenditures (PSDP) on private investment have been both positive and significant. At the end of the paper, they suggested that it is important to follow a national eco-political policy that increases Pakistani GDP. They said the policy attract local private investment which would attract FDI to follow. They did mention that it is difficult for them to collect the data for different variables for the past few decades

which caused the analysis of the determination of study explanatory variables is not comprehensive enough. (Haroon and Nasr , 2010)Drukker, Gomis-Porqueras and Hernandez-Verme (2005) use the full sample of 138 countries over the period 1950-2000. In order to throw new light on the question of the super-neutrality of money, this paper applies new econometric techniques for estimation and inference in panel-data models with threshold effects to standard datasets. They find strong evidence that inflation has a nonlinear effect on growth. In particular, their results support the newer theoretical work in which inflation has a negative effect on growth, but only after inflation reaches a threshold level. Faria and Carneiro (2001) they use a bivariate time series model including the inflation rate and real output for the period January 1980 to July 1995. For their VAR to be applicable, the VAR is estimated with the change in the inflation rate and output growth. They have investigated the integration properties of the data using standard Dickey-Fuller and Augmented Dickey-Fuller unit roots tests. They interpret this as evidence that Brazil has experienced permanent inflation shocks. Thus, their results suggest that permanent inflation shocks do not have significant permanent effects on output growth rates. Their results also show that there is a negative impact of inflation on output in the short run. Thus, despite the fact that our long-run results support Sidrauki's superneutrality of money, their short-run result cast doubt on the short-run implications of Sidrauski's model for separable utility functions. Hussain (2005) his paper primarily meant to estimate threshold level of inflation in Pakistan using annual data for the period 1973-2005. For the estimation of threshold of inflation, this paper also follows nonlinear approach used by

various researchers. As conclusion the contemporaneous inflation is found to have a significant positive impact on economic growth up to 5 percent inflation rate. Khan and Senhadji(2000) using the dataset includes 140 countris(comprising both industrial and developing countries)and generally covers the period 1960-80. The empirical results strongly suggest the exitence of a threhold beyond which inflation exerts a negative effect on growth. The threshold is lower for industrial than for developing countries (the estimates are 1-3 percent and 7-11 percent for industrial and developing countries, respectively, depending on the estimation method). Furthermore, Khan and Senhadji(2001) using dataset includes 140 countries (comprising both industrial and developing countries) and generally covers the period 1960-98. Estimation has been carried out with a method called conditional least squares. The empirical results strongly suggest the existence of a threshold beyond which inflation exerts a negative effect on growth. The negative and significant relationship between inflation and growth for inflation rates above the threshold level is robust with respect to the estimation method, perturbations in the location of the threshold level, the inclusion or exclusion of high-inflation observations, data frequency, and alternative specifications. Interestingly, using yearly data yields threshold levels that are close to the estimates from the five-year-averaged data (12 percent for developing countries and 3 percent for industrial countries) and a stronger negative relationship between inflation and growth. Joseph Magnus Frimpong and Eric FosuOteng-Abayie(2010) estimated the threshold effect of inflation in Ghana for the period 1960-2008 using threshold regression models. The threshold regression model is developed by Khan and Senhadji

(2001) for the analysis of the threshold level of inflation. They found evidence of a threshold effect of inflation on economic growth in Ghana. The result indicates inflation threshold level of 11% at which inflation starts to significantly hurt economic growth in Ghana. Below the 11% level, inflation is likely to have a mild effect on economic activities, while above this threshold level, inflation would adversely affect economic growth. Similarly, Yasir Ali Mubarik(2005) estimates the threshold level of inflation in Pakistan by using threshold regression model he analysis the threshold level, with annual dataset from 1973 to 2000. The threshold model estimation recommends 9 percent threshold inflation level for economic growth at which inflation is red alert for economic growth. Stephanie Kremer, Alexander Bick and Dieter Nautz(2009) The empirical analysis is based on a large panel-data set including 124 countries during the period from 1950 to 2004. In the following empirical application, they introduce a dynamic panel threshold model that extends Hansen's (1999) original set up by considering endogenous regressors including lags of the dependent variable and adopt the cross-sectional threshold model of Caner and Hansen (2004), where GMM type estimators are used in order to allow for endogeneity, to a dynamic setting. As a result they found that inflation distorts economic growth provided it exceeds a certain critical value. However, there are important differences for industrialized and non-industrialized countries concerning both the level of the estimated inflation threshold and the impact of inflation in the various inflation regimes. For industrialized countries, our results support the inflation targets of about 2% which are more or less explicitly announced by many central banks. In particular, we estimated that inflation dampens

growth if it exceeds a critical value of 2.5%. For non-industrialized countries, the estimated inflation threshold is about 17%. The higher inflation threshold for non-industrialized countries could be explained by the widespread use of indexation systems, which many non-industrialized countries have adopted due to a long history of inflation.