FACULTY OF ECONOMICS
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Thesis

Analysis of Relationship between inflation and Economic Growth: Case of Indonesia

BY

WIRMA SARI
05 151 045

The student of Bachelor Degree of Economic Department

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University Alumnus Registration No:	**Wirma Sari**	Faculty Alumnus Registration No:

Personal Identity

a). Date of Birth: Padang/ 12 Januari 1988 b). Parents' name: Suwirman, A.Md and Fatimah, S.Pd c).Faculty: Economy d). Department: Economy e). Student Id No : 05 151 045 f). Date of Examination: 6 Maret 2009 g) Graduate Standard: With Honor h) GPA: 3,49 i) Length of Study Period: 3years 6months j) Parents' adress: Jl. Rimbo Data No. 15 Bandar Buat, Padang 25231

Analysis of the Relationship between Inflation and Economic Growth: Case of Indonesia

Thesis by: Wirma Sari Thesis Advisor: Prof. Dr. Nurzaman Bachtiar

ABSTRACT

This research is mainly aimed to analyze relationship between inflation and economic growth in Indonesia from 1980 to 2007. This research is conducted by using Ordinary Least Square (OLS) Method to identify relationship between inflation and economic growth and using structural break term to find out what level of inflation that may have jeopardize effect on economic growth. The results show that there is statistically negative and significant relationship between inflation and economic growth. Furthermore, there is significant existence of structural break point and the structural break point of inflation is 7%. Whenever the inflation jumps over the structural break point then it will cause harmful effect on economic growth. In order to find this point, the writer conducts about 14 regressions with structural break term.

Keywords: Economic growth, inflation and structural break point

This thesis has been presented before the examiners in the Thesis Examination and successfully passed the Thesis Examination on March 6, 2009.
The Abstract has been approved by the advisor and the examiners:

Signature			
Full name	Prof. Dr. Nurzaman Bachtiar	Dra. Laksmi Dewi, M.Si	Syon Syarid, SE,ME

Approved by :
Head of Depertment : Prof.Dr.H.Firwan Tan.SE.M.Ec.DEA.Ing
NIP.130812952

Signature

The Alumnus has registered to the Faculty of Economy of/ Andalas University and has obtained the Alumnus Registration Number.

	The officer in charge of Faculty /Andalas University	
Faculty Alumnus Registration No :	Name	Signature
University Alumnus Registration No :	Name	Signature

CHAPTER I
INTRODUCTION

1.1 Background

Inflation as one of important subjects is regarded as an economic phenomenon. It can be defined as a permanent increase in the aggregate price level which implies a diminishing of purchasing power and increase the cost of living (Osama D. 2004). Since inflation diminish purchasing power and increase living cost, it is generally believed that inflation may have harmful effect on economy as a whole, one possible undesirable consequence of high inflation rate is to increase inflation uncertainty about future profitability of investment projects especially when high inflation is also associated with increased price variability. This leads to more conservative investment strategies, ultimately leading to lower levels of investment and economic growth.

Inflation may not only affect the economy through its uncertainty but also may reduce a country's international competitiveness, by making its exports relatively more expensive, thus impacting on the balance of payments. Moreover, inflation can interact with the tax system to distort borrowing and lending decisions. Firms may have to devote more resources to dealing with the effects of inflation for example, more vigilant monitoring of their competitors' prices to see if any increases are part of a general inflationary trend in the economy or due to more industry specific causes (Vikesh Gokal and Subria Hanif, 2004).

The relationship between economic growth and inflation is one of the most important macroeconomic problems which are not only experienced by emerging countries but also advanced countries. Indonesia may always deal with this macroeconomic problem.

There are great number of literatures that study the relationship between inflation and economic growth. This relationship has been debated in economics literature and these debates have shown differences in relation with the condition of world economy. The results show that the possibility to have either a positive or negative relationship between inflation rate and economic growth exists.

With the World Economic Crisis of 1929, Keynesian policies have been effective on the countries. In accordance with these policies, increases in the total demand have caused increases not only in products but also in inflation. However, inflation was not regarded as a problem in that period; instead the view stating that inflation has a positive effect on the economic growth was accepted. Among these views, Phillips Curve comes in the first place which hypothesizes that high inflation positively affects the economic growth by contributing creation of a low unemployment rate.

When it came to the 1970s, the fact that growth rates began to decrease in countries with high inflation rates and especially high inflations and hyperinflations occurred in Latin American countries in the 1980s has caused the emergence of the views stating that inflation has negative effects on the economic growth instead of the views stating that inflation has a positive effect on the economic growth and strengthened these views.

Capital Formation assumes paramount importance in the context of policy making by a country. It acts as an indicator in the measurement of economic growth of a country. It reveals the potentially of the investments in the public as

CHAPTER VI
CONCLUSIONS AND RECOMMENDATIONS

6.1 Conclusions

This research is mainly aimed to analyze the relationship between inflation and economic growth in Indonesia period 1980 to 2007. In addition it also aimed to analyze the effect of money supply on economic growth and to analyze the effect of Gross Fixed Capital Formation on economic growth.

In order to achieve those aims mentioned above, the writer employs Ordinary Least Square (OLS) method. First step, the estimating model is regressed by using ordinary least square (OLS), without the structural break. By using this method, the writer has found the relationship among independent variables and dependent variable. Next step, in order to find what level of inflation may have harmful effect on economic growth; the estimating model is regressed with the structural break term.

Estimated model without structural break point results shows that there is negative and significant relationship between inflation and economic growth. 1% increase in inflation rate leads to reduce economic growth by 0.317%. Furthermore, the results also show positive and significant relationship between GFCF and economic growth, 1% increase in GFCF leads to increase GDP for about 0.092%. But negative relationship between M2 and economic growth, this is not the same as hypothesis; however the data is insignificant that can be seen from the simple t-test suggesting coefficient regression which is insignificant.

Estimated model with structural breakpoint results show what level of inflation may have jeopardize effect on economic growth. 7 % is emerged level in

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