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DỊCH  
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ANH  
CHUYÊN  
NGÀNH  
NHANH  
NHẤT VÀ  
CHÍNH  
XÁC  
NHẤT**

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Liên hệ dịch tài liệu :

[thanhlam1910\\_2006@yahoo.com](mailto:thanhlam1910_2006@yahoo.com) hoặc [frbwrthes@gmail.com](mailto:frbwrthes@gmail.com) hoặc số 0168 8557 403 (gặp Lâm)

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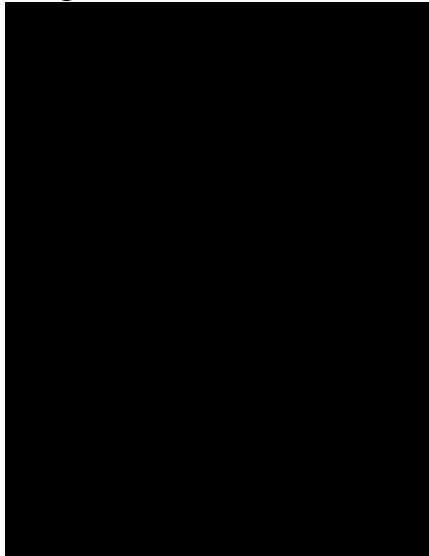
### 2.1. Theoretical studies Inflation - Growth

Numerous theoretical studies investigated the association between inflation and growth. They can be divided into two groups. The first one contains

2.1 Các nghiên cứu lý thuyết về lạm phát-tăng trưởng  
Đã có nhiều nghiên cứu tập trung vào vấn đề mối quan hệ giữa lạm phát và tăng trưởng. Các nghiên cứu này

inflation among dependent variables. For instance, the models by Clarida, Gali and Gertler (1999) and Gali and Gertler (2007) are given by a system of three blocks of equations, describing aggregate demand, aggregate supply and monetary policy. These models are based on real business cycle theory, extended with monopolistic competition and nominal price rigidities, and its main difference from the traditional Keynesian model, according to the authors, is that “all coefficients of the dynamic system describing the equilibrium ... are explicitly derived from the underlying theory“. In this framework inflation influences real output through real interest rate channel (Fisher equation) in the demand block and affects growth through expectation in prices in the supply part. A different group of growth models does not explicitly include inflation in their framework. This group contains, among other models, the endogenous growth model for a small open economy developed by Minford and Meenagh (2006) and the endogenous growth model with public goods proposed by Barro (1998). These models are derived from an intertemporal utility function and perfect competitive firm sector with some production function. These frameworks differ from

được chia thành hai nhóm. Đối với nhóm thứ nhất, lạm phát là một trong nhiều biến phụ thuộc. Chẳng hạn, mô hình của Clarida, Gali và Gertler (1999) và Gali và Gertler (2007) được biểu diễn qua hệ ba phương trình, mô tả tổng cung, tổng cầu và chính sách tiền tệ. Những mô hình này dựa trên lý thuyết chu kỳ kinh tế thực, được mở rộng với cạnh tranh độc quyền và sự cứng nhắc giá danh nghĩa và sự khác biệt chính của nó với mô hình Keynes truyền thống, theo các tác giả, là “tất cả các hệ số của hệ động mô tả sự cân bằng....được rút ra một cách tường minh từ lý thuyết cơ bản”. Trong khuôn khổ này, lạm phát tác động đến sản lượng thực thông qua kênh lãi suất thực (phương trình Fisher) trong khối cầu và tác động đến tăng trưởng thông qua kỳ vọng về giá trọng phần cung. Một nhóm mô hình



each other by some minor assumptions, having at the same time the common result – they determine a steady-state growth rate endogenously.

Therefore, while the first group of models explicitly includes inflation as a factor of economic growth, the second group does not. However, the policy makers are particularly interested in first group of the models, hence we will concentrate on it.

A common problem of many theoretical models is that the resulting systems of equations, which are obtained from the underlined assumptions, are highly dimensional and non-linear, which makes it hard to solve them in closed form without additional assumptions or some transformations. For instance, the basic equations for aggregate demand, aggregate supply and policy function form the three-dimensional system, which can be solved in general form only for few non-linear specifications. One of the most popular methods is linearization which allows simplifying considerably the initial system and obtaining a solution in a feasible way. However, after this

transformation all non-linear effects inside the model disappear.

At the same time several theoretical studies argued that depending on its level, inflation can either promote or harm economic growth. For instance, Lucas (1973) explained that low inflation allows overcoming rigidity of nominal prices and wages. In addition, inflation can realign relative prices in response to structural changes in production during fast modernization periods. In this case inflation is quite important for economic growth. On the other hand, high inflation creates “shoe leather costs” and “menu costs”, discourages long-term investments and distorts a tax system (Romer, 2001). In addition, let’s consider different types of channels through which inflation influences economic growth. Several recent studies discussed interesting features of non-linearity in growth-inflation association. For instance, Huybens and Smith (1998, 1999) stated that even predictable inflation may harm economic growth by impeding financial sector allocating resources effectively. Other theoretical studies focused on the question of how expected inflation impacts the financial system. For example Choi et al. (1996) and Azariadas and

Smith (1996) showed that only when inflation exceeds some critical level then it hampers economic growth, otherwise inflation has a favorable impact on growth. The authors explained this phenomenon using the so-called “adverse selection mechanism” in credit market. The brief idea is the following. There are two types of agents in the financial system: “natural borrowers” and “natural lenders”. The latter have enough funds to invest but do not have access to projects, while the former have many projects but insufficient funds to undertake them. The financial system plays an important role in order to ensure a channel from lenders to borrowers.

If inflation increases then it reduces the real rate of return on assets. In such circumstances more people want to be borrowers rather than savers. At the same time new borrowers have higher default risk because they were not initially interested in getting credit, creating an adverse selection problem for investors, which is called credit market rationing. However investors

will not be interested in providing loans for new borrowers, causing fewer loans in the financial market. As a result, a current increase in inflation rate leads to lower economic growth in the future. The opposite situation takes place when inflation rate is reasonable low. In this case credit market will operate in a Walrasian way and “adverse selection mechanism” will be absent. Then model will generate Mundell-Tobin Tobin effect (Choi et al., 1996, Azariadas and Smith,1996), which means that increase of inflation rate will cause substitution between resources that is agents will prefer to replace cash with human or physical capital. . Therefore, economic growth will be promoted (Choi et al., 1996). However, if inflation becomes higher than the threshold level, then credit rationing in the financial market appears harming growth.

Hence, there are theoretical arguments for a positive inflation-growth relationship for low levels of inflation and a negative one for high levels. Consequently, an inflation-growth relationship is non-

linear and there exists some inflection point which changes impact from favorable to adverse. As is discussed in the next subsection, different econometric approaches can be used to estimate this relationship.

### **Empirical studies**

Existing empirical studies, just as theoretical models, reflect different views on the relationship between inflation and output growth. Their findings differ depending on data periods and countries, suggesting that the association between inflation and growth is not stable. Still, economists widely accept the existence of a non-linear and concave relationship between these two variables. The traditional point of view does not consider inflation as an important factor in growth equation. This is reflected in the studies by Dorrance (1963) and Johanson (1967), who did not find any significant impact of inflation on growth in the 1960s. Nevertheless, the traditional point of view changed when high and chronic inflation was present in many countries in the 1970s. As a result, different researchers showed that inflation has a negative impact on output growth. Fisher (1993) and de Gregorio (1992, 1994) have

investigated the link between inflation and growth in time-series, cross section and panel data sets for a large numbers of countries. The main result of these works is that there is a negative impact of inflation on growth. Fisher (1993) argued that inflation hampers the efficient allocation of resources due to harmful changes of relative prices. At the same time relative prices appear to be one of the most important channels in the process of efficient decision-making. Barro (1997) used a panel data for 100 countries over the period 1960-1990 and estimated growth regression using Instrumental Variables (IV) technique. He obtained clear evidence that a negative relationship exists only when high inflation data was included in the sample. But there is not enough information to argue that the same conclusion holds for lower inflation rate. Barro has estimated that 10% of inflation reduces real GDP per capita by 0.2% per year.

Despite the fact that adverse impact of inflation is quite small in percentage expression, the long-term effects on



standards of living in nominal values may be considerable. Furthermore, some other studies have shown that the link between inflation and growth is significant only for certain levels of inflation. For instance, Bruno and Easterly (1995) studied inflation-growth relationship for 26 countries over the 1961- 1992 period. They found a negative relationship between inflation and growth when level of inflation exceeds some threshold. At the same time they showed that impact of low and moderate inflation on growth is quite ambiguous. They argued that in this case inflation and growth are influenced jointly by different demand and supply shocks thus no stable pattern exists. Recently, numerous empirical studies found that inflation-growth interaction is non-linear and concave. In particular, Fischer (1993) was the first who investigated this non-linear relationship. He used cross-sectional data covering 93 countries. The author used the growth accounting framework in order to detect the channels through inflation impacts on growth. As a result, he found that inflation influences growth by decreasing productivity growth and investment. Moreover, the author showed that the effect of inflation is non-linear with breaks at 15 and 40 percent

Sarrel (1995) found the evidence of structural break in interaction between inflation and growth. He used fixed effect technique to deal with panel data sample covering 87 countries over 21 years (1970-1990). The main result is that the estimated threshold level equals to 8 percent, exceeding which leads to negative, powerful and robust impact of inflation on growth. Khan and Senhadji (2001) investigated the inflation-growth interaction for both developing and developed countries applying the technique of conditional least squares. They used the panel data set on 140 countries (both industrial and developing) over the period 1960-1998. The authors employed the method of non-linear least squares to deal with non-linearity and non-differentiability of the inflation threshold level in growth regression. As a result, they obtained estimates of the threshold levels of 1-3% for developed and 11-12% for developing countries, which turned out to be very precise. The authors mentioned that the total negative effect of inflation may be underestimated due to the fact that they controlled

investment and employment, so the main channel of impact is productivity. Nevertheless, this study asserted the idea that low inflation is a good thing for the economy because it has favorable influence on growth performance. Christoffersen and Doyle (1998) investigated the nonlinear relationship between inflation and growth for 22 transitional countries over the time period from 1990 to 1997. They used Sarrel's (1995) approach to modeling the kinked interaction between inflation level and economic growth. As a result, the authors found that threshold level is 13%. They did not find any evidences that output will be rapidly increased by high inflation for countries that keep inflation below this threshold level. This result showed that policy makers should keep inflation at some specific threshold level where the favorable impact of inflation on growth performance is the highest.

**Review of Empirical Findings  
: Consumption and Growth  
Evidence pointing towards a  
negative relationship**

Starting with the US economy, Knoop (1999) using time series



data from 1970 to 1995 found that a reduction in the size of the government would have an adverse impact on economic growth and welfare. Estimates obtained by Fölster and Henrekson (1999, 2001) when conducting a panel study on a sample of rich countries over the period 1970-1995 lent support to the notion that large public expenditures affect growth negatively. In another empirical study, Ghura (1995), using pooled time-series and cross-section data for 33 countries in Sub-Saharan Africa for the period 1970-1990 produced evidence that points towards the existence of a negative relationship between government consumption and economic growth. In that study the sample countries were classified into four groups: high-growth countries with growth rates above 2.0%; medium-to-low-growth countries, with growth between 0% and 1.9%; weak-growth countries, with growth between -1.0% and -0.01%; and very-weak-growth countries, with growth below -0.9%. During his investigation it transpired that, the fact that higher growth countries experienced higher investment ratios, higher export volume growth, higher life expectancy at birth, lower inflation rates, and lower standard deviations of inflation did not necessarily imply better

terms of trade outcome.

Barro (1991) in a cross section study of 98 countries for a period spanning from 1960 to 1985, using average annual growth rates in real per capita GDP and the ratio of real government consumption to real GDP concluded that the relation between economic growth and government consumption is negative and significant. Additional evidence suggested that growth rates were positively related to measures of political stability and inversely related to a proxy for market distortions. Jong-Wha Lee (1995) produced further evidence on the relationship between government consumption and economic growth. More specifically, by using an endogenous growth model of an open economy, it was found that government consumption of economic output was associated with slower growth. In addition, the composition of investment and the volume of total capital accumulation were also thought to significantly condition economic growth.

In an attempt to investigate the

relationship between government size and the unemployment rate. Burton (1999) using a structural error correction model for twenty OECD countries from 1970 to 1999, found that government size, measured as total government outlays as a percentage of GDP, played an instrumental role in affecting the steady-state unemployment rate, i.e. unemployment rises. Further evidence obtained using disaggregated government expenditure pointed towards a significant relationship between, transfers, subsidies and the steady-state unemployment rate while government expenditures on goods and services was found to be insignificant. Using pooled cross-section/time-series data on 113 countries, Grier and Tullock (1989) investigated empirical regularities in post-war economic growth. Among other results, they found that government consumption is negatively associated with economic growth. From the same study it also emerged that political repression is negatively correlated with growth in Africa and Central and South America. Guseh (1997) in a study on the effects of government size on the rate of economic growth conducted OLS estimation, using time-series data over the period

1960 –1985 for 59 middle-income developing countries. The yielding evidence suggested that growth in government size has negative effects on economic growth, but the negative effects are three times as great in non-democratic socialist systems as in democratic market systems. Further estimates provided by Engen and Skinner (1992) for 107 countries over the period 1970-1985, suggested that a balanced-budget increase in government spending and taxation is predicted to reduce output growth, whilst Carlstrom and Gokhale (1991) reported simulation results according to which government expenditures increases caused a long-run decline in output. Adopting a Granger causality approach, Conte and Darrat (1988), investigated the causal dimension between public sector growth and real economic growth rates for the OECD countries. Special emphasis was put on the feedback effects from economic growth to government growth that resulted from macroeconomic policy. On the basis of the yielding evidence, government growth has had mixed effects on economic growth rates, positive for some countries and negative for others. For the bulk of the OECD economies however, no discernable impact

of government growth on the rate of real economic growth was perceived. Evidence pointing towards a positive relationship Contrary to the negative association between government spending and economic growth established by the aforementioned studies a growing body of literature attempts to redress the balance by suggesting that the state can actually, through implementing appropriate policies, nurture productive activities and reduce unproductive ones (see for instance Amsden, 1989; Epstein and Gintis 1995, Burton 1991). More specifically, Kelly (1997) by exploring the effects of public expenditures on growth among 73 countries over the period 1970-1989 found that the crowding-out and rent-seeking concerns might have been overstated in the literature. According to the evidence obtained the contributions of public investment and social expenditures to growth is rather significant. Further more, Alexiou (2007) in a study for the Greek economy, after disaggregating government spending, reported evidence on the basis of which there is a positive association between the growth in the components of government spending and GDP growth. Aschauer (1990) also documented a positive and significant relationship between government spending



and the level of output. Despite the fact that even the crowding-out literature, has recognized a limited but significant effect of public investment on growth, social programmes have been rendered unproductive, with the exception of education. Thereby, most of the studies conducted have exclusively focused on education as a significant factor which impacts growth through its effect on human capital (Barro, 1991; Roubini and Sala-I-Martin, 1991; Birdsall, Ross and Sabot 1995). In sketch of the preceding exposition it becomes apparent that the relationship between government spending and economic growth is far from clear. Two key points however can be made when reviewing the empirical studies: empirical results are specification sensitive and the relationship between government spending and economic growth is generally negative when the former is expressed as percent of GDP and is generally positive when expressed as an annual percentage change.

#### REVIEW OF RELATED LITERATURES: M2 and Growth

As already explained money supply exerts considerable influence on economic activity in both developed and developing economies. The low level of supply of monetary aggregates in general

and money stock in particular had been responsible for the fundamental failure of many African countries to attain growth and development. Various scholars have laid much of the blame for the failure of monetary policies to translate into economic growth on the government and its agencies as a result of poor implementation and insincerity on the part of policy executors. Until recently, with the recapitalization in the banking sector which resulted in mergers, acquisitions increased bank branches and innovations of new products and technology coupled with growth in the capital markets, the Nigerian financial system remained by and large relatively underdeveloped because of lack of financial intermediation and financial deepening which the economy requires for sustained growth. In an attempt to link money supply to economic growth recent contributors in the new economic growth literature have considered the role of financial structure, this presupposes that the level of money stock drives economic growth. These assertions will strictly depend on several macroeconomic variables. Montiel (1995), Emenuga (1996) and Osikoya (1992) all submitted that, possible effect of financial depth (money in circulation) on economic

growth can manifest in three channels: (a) improved efficiency of financial intermediation (b) improved efficiency of capital stock and (c) increased national savings rate. Fishlow (1996), Bardhan (1996) and Horton et al. (1995) among others provide succinct statements of the historical perspective of issues involved and discuss the various implications of received interest in monetary aggregates in the determination of the level of economic growth in developing countries. Prior to the publication of Kuznets' (1955) paper "Economic Growth and Income Inequality" economic development and growth were guided by the belief that the benefits of economic growth will eventually trickle down in such a way as to affect the velocity of monetary aggregate. Modern macro-economic theories of money and economic development seem to agree that there exist a systematic relationship between money and economic development (Bemanke Alan et al. 1992; Ghatak 1995). However, empirical researches have largely focused on addressing two issues. First, to examine if money could forecast output given predictive power of past values of output. If so, the second issue is to examine whether such relationship is stable over time

or not. Some researchers have found evidence of the predictive ability of monetary aggregates (Beckett and Morris 1992; Krol and Chanian 1993). Though, some of these studies argued that such relationship seems to have changed over time (Beckett and Moris 1992). Hum (1993), disagrees with the observed causality that runs from money to income using evidence from South African data. Jeong (2000) using Thailand socio-economic survey concludes that growth and inequality are strongly associated with money supply and financial deepening. Similar studies that have found a strong support for a positive relationship between money supply and growth include (Sims 1972; Wecllock 1995; Friedman and Meiselman 1963; Cagan 1956; Christ 1973; Greenwood and Jovanovic 1990 and Heber 1991, 1996) Others include (King and Levine 1993b; Wachtel and Rousseau 1995 and Neusser and Kinglert 1996). Others include Acemoglu and Ziliboti (1997), DeNardi (2004), Mansor (2005), Townsend and Ueda (2005) and Owoye and Onafowora (2007). In Nigeria however, the influence of money supply on economic growth can only be taken with mixed reactions. Albeit, several studies have confirmed the significance of money supply

and economic growth. Between 1971 and 1975, the growth rate of the economy measured by the real GDP ranged from 21.3% in 1971 to 3.0% in 1975. By 1981, the real GDP grew by 26.8% and remained negative till 1984 (see appendix I). A simple variance analysis shows that between 1971 and 1986, the mean spread of the GDP was 108.7. However, between 1986 and 1994, the real GDP had a variance of 9.1. The variability of the GDP was much higher before deregulation, while it becomes lower during and after the deregulation of the economy.