

Exploring the Impact of Inflation on Economic Development in Bangladesh

Md. Sayebur Rahman

Abstract

A moderate and stable inflation rate helps a country's development and hence economic growth. A modest degree of inflation supplements savers' returns, boosts investment, and thereby promotes a country's economic growth. This article empirically investigates the current link between inflation and economic development in Bangladesh, utilizing data on GDP growth and GDPD as a proxy for inflation from 1960 to 2018. The Granger Causality Test, unit root test, Co-integration, and VECM were used to evaluate empirical data. According to the empirical data, there is a statistically substantial long-run negative association between GDPD and GDP, demonstrating an adverse correlation between inflation and economic development. Again, data showed that there is long-run positive causation between GDP and GDPD. Furthermore, the threshold level of inflation has a beneficial outcome on economic growth, but inflation has a detrimental influence on economic growth if it reaches the threshold level. The key policy implications of the empirical findings are summarized in this study.



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1. Introduction:

Inflation, measured as the proportion of change in the overall price level of services and goods, has a substantial impact on a country's economic growth. A moderate and stable inflation rate can boost investment, supplement savers' returns, and promote economic development. However, high inflation can have detrimental effects on a country's economic growth. The current study aims to empirically investigate the link between inflation and economic development in Bangladesh. Utilizing data on GDP growth and GDPD as a proxy for inflation from 1960 to 2018, the study employs various statistical techniques such as the Granger unit root test, causality Test, VECM, and Co-integration to evaluate the empirical data. The study's findings provide insight into the relationship between inflation and economic development in Bangladesh and have important policy implications for policymakers. In this study, we aim to investigate the relationship between inflation and economic development in Bangladesh. Using data on GDP growth and GDPD as a proxy for inflation from 1960 to 2018, we will apply statistical techniques such as the Granger Causality Test, unit root test, co-integration, and VECM to evaluate the empirical data. Our findings will provide insights into the effect of inflation on economic development in Bangladesh and the threshold level at which inflation becomes detrimental to economic growth. Over the last few decades, macroeconomists, policymakers, and central bankers have debated whether inflation is required for country's economic growth or is destructive to the economy of both rich and developing countries around the world. When the inflation rate is high, it might cause an investment project to be unclear about its future profitability. This high inflation is accompanied by greater price volatility. Price fluctuation decreases a country's global competitiveness by raising the cost of exports. Several research and theories have been developed to investigate the link between inflation and economic growth. Several studies have shown no clear empirical result for an association between inflation and economic development. In this regard, Tobin (1965), Mundell (1963), and Gregorio (1999) forecast a positive association between the rate of capital accumulation and the rate of inflation implying an optimistic association between the economic growth and the inflation rate. According to some research, there is no substantial empirical indication of a positive or negative link between the rate of inflation and economic growth; notable examples include Johansen (1967), Dorrance (1963, 1966), Bhatia (1960) and Wai (1968, 1959). In contrast, other study has shown a nonlinear and adverse connection between the rate of inflation and the rate of economic growth. Barro (1995), Bruno and Easterly (1999), and Fishchera and Modigliani (1978) are among them. In this backdrop, the goal of this article is to empirically investigate the link between inflation and economic development in Bangladesh, as inspired by Ahmed and Mortaza (2005), Md. Shakhaowat Hossin (2015), Sumon and Miyan (2017). Several economic theories and empirical research will be examined to establish whether there is a meaningful link between inflation and economic growth in Bangladesh. All of the data used in this article were collected using yearly data sets on real GDP and GDP deflator (from 1961 to 2018). The following is how this document is structured: Section one provided the paper's introduction, the second section looked at the literature on inflation rate and economic growth; Section three offered information on historical inflation and economic growth patterns in Bangladesh; and Section four detailed the model and technique used to generate the conclusions stated in this article. Section five covers the paper's expected inflation and economic growth outcomes, while the last section offers the study's summary and conclusion. The rate of economic growth is usually defined as the rate of increase of real GDP.

2.Literature review related to country's Inflation and Economic Growth

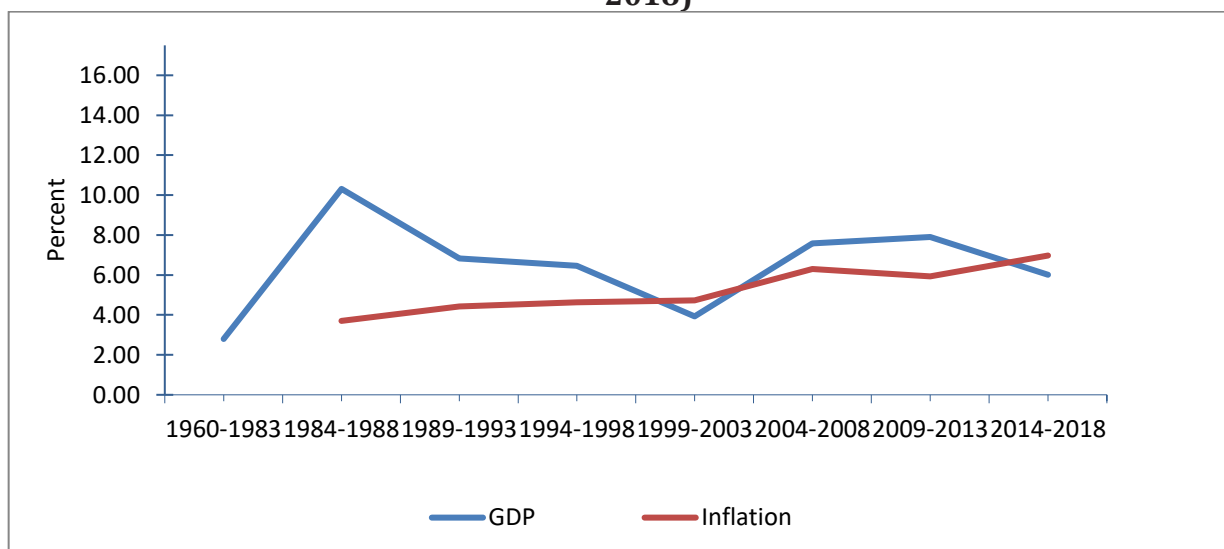
Barro (1995) conducted an investigation of the connection between countries' inflation and economic development in over 100 countries from the year 1960 to 1990. His research found that there was a statistically substantial adverse relationship between the two factors. He also found that there are reasons to believe that higher longstanding inflation can negatively impact country's economic growth. Similarly, Bruno and Easterly (1996) looked into the factors that drive economic growth by analyzing from 26 countries monthly CPI inflation data that experienced inflation emergencies between 1961 and 1992. They found that inflation crises occurred when the inflation rate reached 40% or higher. When inflation crises were excluded, the results suggest an uncertain association between the rate of inflation and economic growth at levels below the threshold. The study also found that there is no correlation between inflation and economic growth above a certain point. Sarel (1995) observed that before the 1970s, inflation rates were generally low, but they began to increase afterwards. Before the 1970s, research revealed that there was a positive relationship between inflation and economic growth, but as inflation rates rose, the association became negative. Malla (1997) carried out an empirical analysis of nations in Asia and the OECD (Organization for Economic Cooperation and Development) to further understand this relationship. In the year 2001, Mallik and Chowdhury conducted an investigation on long-term and the short-term association between countries' inflation and economic growth in four South Asian countries: Sri Lanka, Pakistan, India, and Bangladesh,. They discovered two positive results. Firstly, they discovered that there was a positive correlation between the inflation rate and economic growth, and this correlation was statistically significant in all four countries. Secondly, they found that changes in the inflation rate were less responsive to changes in growth rates, than changes in growth rates were to changes in the inflation rate. Ahmed and Mortaza (2005) utilized multiple methods to analyze the connection between inflation and economic development in Bangladesh from 1981 to 2005. They found that there was a statistically significant long-term negative association between inflation and economic growth in Bangladesh. Mubarik (2005) examined the correlation between inflation and economic growth in Pakistan by determining the threshold level of inflation using annual data from 1973 to 2000. Kasidi and Mwakanemella (2013) employed the co-integration method and the correlation coefficient to investigate the relationship between Tanzanian inflation and economic development from 1990 to 2011. The correlation coefficient revealed a negative relationship between inflation and economic growth in Tanzania, while the co-integration approach indicated no long-term association between inflation and economic growth. In the study by Ahmed and Zaid (2016), the relationship between inflation and economic growth in the United States from 1960 to 2011 was analyzed using the same methods as Khan and Senhadji. The research found that when inflation reaches a certain threshold level, it negatively impacts real GDP. However, when inflation falls below that threshold, the effect on GDP is not clear. Khan and Schimmelpfenning (2006) also examined the link between inflation and economic growth, using Pakistani data from 1998 to 2005 to study the relationship between the CPI and private sector lending. They found that while there is no correlation between inflation and growth in the short term, there is a relationship in the medium and long term. In 2017, Sumon and Miyan examined the relationship between inflation and economic growth in Bangladesh, as well as the inflation threshold, over a 30-year period from 1986 to 2016. Their study found a strong connection between the two factors, and determined that inflation adjusts at a rate of approximately 79% each year. Additionally, they calculated the expected inflation threshold level to be 8%, which they deemed important information for policymakers. In 2015, Hossain conducted research on the relationship between inflation and economic development in Bangladesh using annual data on real GDP and the GDP deflator from 1961 to 2013. The findings showed a negative correlation between inflation and economic growth, and a positive correlation between GDP

and the GDP deflator. Similarly, Majumder (2016) also examined the relationship between inflation and growth in Bangladesh from 1975 to 2013 and discovered a strong, positive long-term correlation. In 1992, De Gregorio attempted to find evidence of a association between inflation and growth in Latin American countries, but the data suggested a negative connection instead.

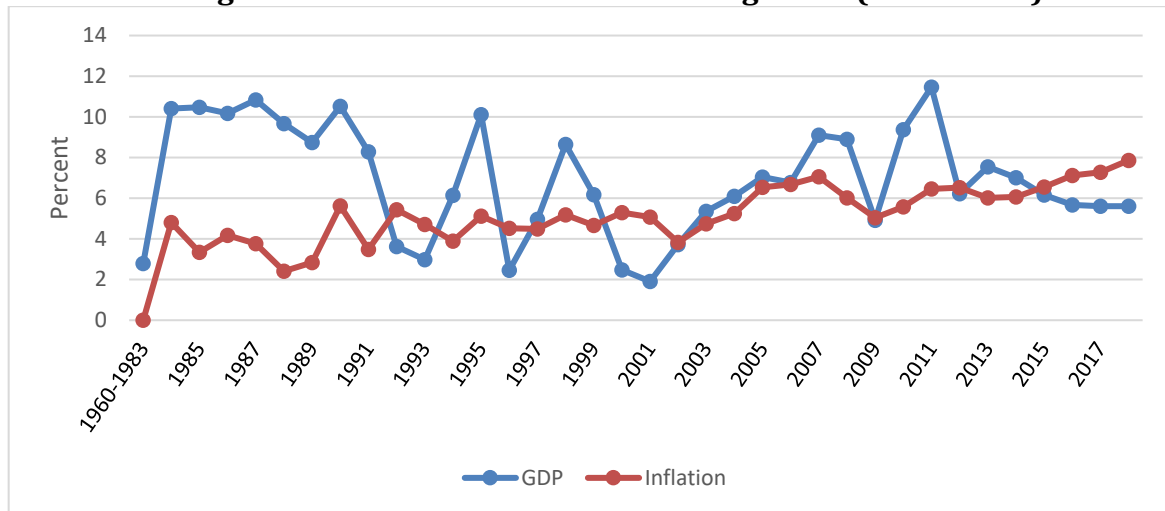
3. Historical Inflation rate and Economic Growth Trends:

Figure 1 depicts the country experiencing double-digit inflation over the first half of the 1980s, while the growth rate averaged less than 4% during these times. However, a mild fall in GDP growth rate is recorded throughout the second half of the 1980s, as well as a lowering inflation rate of less than 8% during this decade. Throughout the 1990s, a modest inflation rate and an increasing GDP rate were noted. During the first decade of the 1990s, there was 6.31% an average inflation rate and 4.63% a GDP growth rate. In contrast, the average GDP growth rate throughout the latter part of the 1990s was 4.80%, with 6.47% an average inflation rate. Following this pattern, the rate of inflation rose on average to 5.52 percent and 7.66 percent in the first and second halves of 2000, respectively. During this time, the average GDP growth rate increased to 5.10 percent and 6.07 percent, respectively. From 2009 to 2013, the average inflation rate was 7.90 percent, and from 2014 to 2018, the inflation rate was 6.01%, while the average GDP growth rate was 5.92% and 6.98 percent, respectively.

Figure: 1 Inflation and real GDP growth average rates during the last five years (1984-2018)



The graph (Figure 2) below displays Bangladesh's historical inflation and real GDP growth rates from 1984 to 2018. Throughout this era, it indicates a more or less positive and negative link between the inflation and the GDP growth rate.

Figure 2: Inflation rates and real GDP growth (1984-2018)

4. Model Specification and Methodology:

To achieve the study's purpose, two econometric models are used to provide empirical data. The first model investigates the degree to which economic growth and inflation are linked. The second investigates the causal association between actual GDP and the GDPD.

4.1. Model Specification:

This study's basic model depicts the connection between inflation and economic growth, stated therefore-

$$GDP = f(GDPD) \quad (i)$$

$$GDP = \alpha_0 + \alpha_1 + GDPD_t + \varepsilon_t \quad (ii)$$

GDP stands for GDP and is used as a proxy for economic growth

GDPD stands for GDP and is used as a proxy for inflation

ε is the random error, α_0 is constant, and t is time.

4.2. Data Sources and Description

To discover the association between country's inflation and economic growth, GDP is utilized as a proxy for economic development, while GDPD is used as a proxy for inflation. GDP and GDPD statistics are available for the years 1984 to 2018. All of the variables in this research are derived on a yearly basis from World Development Indicators (WDI), which are available online at the World Data Bank.

4.3. Technique Estimation:

4.3.1. The Unit Root Test (URT):

The ADF (Augmented Dickey-Fuller) examination, created by Dickey and Fuller (1981), is the most extensively used and popular exam. The unit root null hypothesis is rejected in favor of the alternative hypotheses in the ADF test. For each series, the ADF tests are performed using deterministic and non-deterministic trends (t). The overall form of the ADF test is approximated as follows-

$$\Delta y_t = \alpha_0 + \alpha_1 y_{t-1} + \sum_{i=1}^n \alpha \Delta y_t + e_t$$

$$\Delta y_t = \alpha_0 + \alpha_1 y_{t-1} + \sum_{i=1}^n \alpha \Delta y_t + \delta_t + e_t$$

Linear time trend is a t

A constant is α_0

time series is a Y

The first difference in operation is Δ

The optimal number of lags is n

the random error term is e which is the difference between equation i and ii

$$\Delta y_t = \alpha_0 + \alpha y_{t-1} + e_t$$

4.3.2. The Co-integration Test

Once a unit for a data series has been validated, the following stages entail analyzing whether there is a long-term association between the factors, which is referred to as co-integration, which is highly important to reduce the possibility of false regression. The core notion underlying co-integration is that if two or more series move together closely over time, even though the series themselves are trending, the space between them stays constant. In the absence of co-integration, these factors have no long-term association and can, in principle, drift arbitrary distances apart (Dickey and colleagues, 1991). We employed Johansen's technique for VAR-based co-integration testing (1991, 1995). Johansen's technique begins with the VAR of order p provided by

$$y_t = \mu + \Delta_1 y_{t-1} + \dots + \Delta_p y_{t-p} + \varepsilon_t$$

y_t is an $n \times 1$ vector of variables that are combined of order commonly denoted (1) and ε_t is an $n \times 1$ vector of innovations

This VAR can be rewritten as

$$\Delta y_t = \mu + \eta_{y_{t-1}} y_{t-1} + \sum_{i=1}^{p-1} \tau_i \Delta y_t + \delta_t + \varepsilon_t$$

Where,

$$\Pi = \sum_{i=1}^p A_{t-1} \text{ And } \tau_i = \sum_{j=i+1}^p A_j$$

4.3.3 The Granger-Causality Test (GCT)

Following the co-integration test to assess if inflation and economic growth have a long-run link, the causality between inflation and economic growth in Bangladesh must be examined. If the two variables are co-integrated, which means they have a connection, an Error correlation term (ECT) must be added in the following autoregression.

$$GDP_t = \alpha_0 + \sum_{i=1}^n \alpha_{1t} GDP_{t-1} + \sum_{i=1}^m \alpha_{2t} GDPD_{t-1} + \delta_1 ECT_{t-1} + \varepsilon_{it}$$

$$GDPD_t = \beta_0 + \sum_{i=1}^m \beta_{1t} GDP_{t-1} + \sum_{i=1}^n \beta_{2t} GDPD_{t-1} + \delta_2 ECT_{t-1} + \varepsilon_{it}$$

Where,

GDP is GDP_t

GDPD stands for GDP Deflator, and it is a proxy for inflation.

ECT_{t-1} is the Error correlation term

The speed of adjustment can be interpreted as δ_1 And δ_2

5. Data and Empirical Results

5.1. The Unit Root Test (URT)

The Unit Root Test entails determining the presence of a unit root in each time series by applying the ADF test to the variables, namely GDP and GDPD. The ADF test results are shown in Tables 5.1.1, which offers the test results at Levels, and Table 5.1.2, which provides the test results at the first difference.

Table 5.1.1. ADF Stationary Test at Levels

Variables	ADF						Remarks
	Intercept		Trend & Intercept		None		
LGDP	-1.797	(-3.5600)* (-2.9176)**	-6.074	(-4.1305)* (-3.4921)**	-0.461	9-2.6093)* (-1.9471)**	Non Stationary
LGDPD	14.045	(-2.59668)*** (-3.54820)*	5.103	(-3.1748)*** (-4.1242)*	20.980	(-1.6128)*** (-2.6054)*	

(-2.9126)**	(-3.4892)**	(-1.9465)**	Non Stationary
(-2.5940)***	(-3.1731)***	(-1.6131)***	

Note * denotes a significant level at 1 percent, ** a significant level at 5 percent and *** a substantial level at 10 percent and figures inside parentheses indicate crucial levels. Mackinnon (1991) used the crucial value of unit root to reject the theory. Author's estimate based on Eviews 10.

Table: 5.1.2. ADF Stationary Test at First Difference

Variables	ADF						Remarks
	Intercept		Trend & Intercept		None		
LGDP	-3.37838	(-3.5744)* (-2.9237)**	-3.46809	(-4.1611)* (-3.5063)**	-6.70632	(-2.6093)* (-1.9471)**	Non Stationary
LGDPD	-0.89607	(-2.5999)*** (-3.5526)* (-2.9145)**	-4.22013	(-3.1830)*** (-4.1273)* (-3.4906)**	0.119346	(-1.6128)*** (-2.6069)* (-1.9467)**	Non Stationary
		(-2.5903)***		(-3.1739)***		(-1.6130)***	

Note * denotes a significant level at 1 percent, ** a significant level at 5 percent and *** a substantial level at 10 percent and figures within parentheses imply important levels. Mackinnon (1991) used a crucial value of unit root to reject the theory. Author's estimation based on Eviews 10.

ADF is used to assess the variables' stationarity. Tables 5.1.1 and 5.1.2 show the results of the ADF test with trend, intercept, and intercept, as well as none. All of the variables discovered in levels were not stationary, as determined by comparing the likelihood, critical value, and absolute values at 1 percent, 5 percent, and 10 percent significance levels. Table 5.1.1 gives substantial evidence of not being steady, implying that we cannot reject the null hypothesis but must accept it. As a result, it is sufficient to conclude that unit root exists in the variables utilized in the test at levels. The coefficients compared to the key values at (1%, 5%, and 10%) in Table 5.1.2 reveals that all of the variables were stationary at the initial difference, and the null hypothesis of non-stationary is rejected based on the comparison, indicating that the variables are integrated.

5.2. Co-integration Test Result and Analysis

5.2.1. Unrestricted Co-integration Rank Test (Trace)

A long-term association is discovered as a result of the cointegration requirement, as shown in Tables 5.2.1 and 5.2.2 show Trace statistics and maximum Eigenvalues calculated using the techniques given by Johansen and Juselius (1990).

Hypothesized No. of CE (s)	Trace Statistic	Eigenvalue	0.05 Critical Value	Prob.**
None*	50.03325	0.420902	15.49471	0.0000
At Most 1 *	19.44136	0.293313	3.841466	0.0000

At the level of 5%, the Trace Test demonstrates two cointegrating equations; * signifies rejection of the null hypothesis; **MacKinnon-Haug-Michelis (1999) p-values

Tables 5.2.1 and 5.2.2 of the Johansen tests for cointegration demonstrate the rejection of the null hypothesis of no cointegration between GDP and GDPD. At a 5% level of significance, the maximum Eigenvalue and Trace tests reveal two cointegration equations, implies that there is a long-run relationship between inflation and Bangladesh's economic progress.

5.2.2. Unrestricted Cointegration Rank Test (Maximum Eigenvalue)

Hypothesized No. of CE (s)	Max-Eigenvalue Statistic	Eigenvalue	0.05 Critical Value	Prob.
None	30.59189	0.420902	14.26460	0.0001
At Most 1 *	19.44136	0.293313	3.841466	0.0000

The Max-Eigenvalue Test reveals two cointegrating equations at the 5% level; * signifies rejection of the null hypothesis at the 5% level; and **MacKinnon-Haug-Michelis (1999) p-values.

Table 5.2.3 displays the estimate coefficient of the vector correction component that deals with long-run effects, as well as the lag values of the two short-run series. The empirical findings of this VECM reveal that the country's inflation and economic growth have both short-run and long-run correlations.

Table 5.2.3. Vector Error Correction Estimates

Error Correlation	D(GDP)	D(GDPD)
CointEq1	-0.818641 (0.22890) [-3.57634]	-0.378494 (0.11174) [-3.38727]
D (GDP (-1))	-0.122315 (0.18647) [-0.65597]	0.374033 (0.09102) [4.10918]
D (GDP (-2))	-0.130480 (0.12988) [-0.93280]	0.221124 (0.06828) [3.23834]
D (GDPD (-1))	-0.164849 (0.28254) [-0.58346]	0.359387 (0.13792) [2.60500]
D (GDPD (-2))	-0.629209 (0.27206) [-2.31277]	0.188749 (0.13281) [1.42123]
C	2.992864 (0.27206) [-2.31277]	0.188749 (0.13281) [1.42123]
Adj. R-squared	0.447464	.766503
R-Squared	0.498825	0.788123
Sum Sq. Resides	714.1773	170.1833
Mean Dependent	0.151266	3.957659
S.D dependent	5.135997	3.856731
S.E. equation	3.817728	1.863633
F Statistic	9.746244	36.45317

5.3. Granger Causality Test Analysis

The most frequent approach for investigating causality is Granger Causality Test Analysis. This test is used to assess the direction of causation as well as the correlation between two variables. According to our examination of the research, there is an inverse link between growth and inflation. On the other hand, battling excessive inflation does not help the economy expand. In this case, Tables 5.3.1 and At lags 2 and 3, 5.3.2 shows the direction of causality between growth and inflation.

5.3.1. Pairwise Granger Causality Tests (Lag 2)

Null Hypothesis	Obs.	F-Statistic	Prob.
GDPD does not Granger Cause GDP	56	5.45125	0.0072
GDP does not Granger Cause GDPD		1.44006	.2464

Table 5.3.1 rejects the null hypothesis that GDPD does not Granger Cause GDP and that GDP does not Granger Cause GDPD, suggesting that Bangladesh's economic growth and inflation are bi-directional at lag two (2).

5.3.2. Pairwise Granger Causality Tests (Lag 3)

Null Hypothesis	Obs.	F-Statistic	Prob.
GDPD does not Granger Cause GDP	56	3.09554	0.0355
GDP does not Granger Cause GDPD		2.75937	0.0523

Table 5.3.2 rejects the null assumption that GDPD does not Granger Cause GDP and that GDP does not Granger Cause GDPD, implying that bidirectional causation exists between Bangladesh's economic development and inflation at lag two (3).

6. Conclusion

The connection between inflation and economic growth in Bangladesh is examined empirically in this article. GDP and GDPD are the data sets utilized in this analysis from 1960 to 2018. The empirical data presented in this study reveal that there is a statistically significant long-run adverse relationship between inflation and economic growth in the country, as measured by GDPD to GDP. Again, empirical data indicates a statistically significant long-run positive correlation as evidenced by GDP to GDPD. The cointegration test, which can be shown in Table 5.2, measures the existence of cointegration between economic growth and inflation by assessing the unit root test for finding the stationarity between the variables. Table 5.3 shows the VAR-Granger Causality technique at lag 2 and lag 3 to assess the causality link between the two variables in addition to this cointegration test. According to the study's findings, economic expansion has a favorable effect on inflation. However, when the inflation rate exceeds the threshold level, it has a detrimental impact on economic growth. Those with low or moderate inflation rates have greater long-term growth rates than countries with high inflation rates, but this does not imply that it is a necessary condition for growth. To encourage the country's economic growth while keeping inflation rates low, the government must limit budget deficits, which may be accomplished by shifting public spending from consumption to investment. This study provides valuable insights for policymakers in Bangladesh to understand the relationship between inflation and economic growth. Additionally, the findings suggest that in order to promote economic growth, it is important for policymakers to target a moderate and stable inflation rate. Moreover, the results of this study can also be useful for other developing countries to understand the relationship between inflation and economic growth in their own economies.

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