

Chapter 1:

Introduction

1.1 Introduction

Throughout the period explored in this paper, 1970 to 2002, there have been fluctuations in primary commodity prices. Classical economists generally believe that commodity prices will continue rising with the development of the world economy. The commodity price shocks, in particular, the oil price and gold price shock, could have very significant impact on the growth rate as both commodities are among the main commodities in the world.

Gillman & Nakov (2000) showed that in the postwar period of last century, oil prices and gold prices have moved in line with inflation rate; including during the stagflation period. Inflation, in turn, has been found to affect the growth rate both ways. Firstly, Chowdhury and Malikk (2001) conducted tests on the inflation and economic growth relationship in four countries namely Bangladesh, India, Pakistan and Sri Lanka and found a long run positive relationship between GDP growth rate and inflation for all four countries. On the other hand, Fischer (1993), Barro (1996), Bruno and Easterly (1998) did a cross-country studies and found inflation to affect economic growth negatively.

On the impact of oil price shock alone on the economy, many economists, including Hamilton (1983) observed the weakening oil price-GDP relationship over time. This is true in the US, where the breakdown in the oil GDP relationship was particularly apparent after 1980s (Hooker (1996)). In addition, Mussa (2000), a researcher at the International Monetary Fund (IMF) have found that the impact of oil price shocks differs between an oil-importing

country and an oil-exporting country as well as between an advanced country (or industrialized country) and a less-developed country.

Many developing countries continue to rely heavily on one or two primary commodities for the bulk of their export earnings, and primary commodities (including fuel and energy) constitute, on average, about half of export revenues of developing countries. Hence, for commodity-dependent countries, knowledge of the duration of such shocks is an essential input to the design of policies to dampen the domestic economic effects of external shocks. A good understanding of the cyclical behavior of commodity prices is equally as important as an understanding of their underlying long-run trends. In particular, reliable estimates of the duration of commodity price cycles are essential when considering counter-cyclical stabilization policies in primary-commodity exporting countries.

Commodity prices affect the economy in various ways. For instance, a commodity price shock would affect the global economy through supply and demand effects as well as via second-round effects on inflation, for example, through higher wage claims. This in turn would affect the extent to which central banks raise interest rates to offset inflationary pressures, and therefore the impact of the oil price increase on real activity. The impact on asset prices and financial markets would provide additional channels.

Generally, we would expect Malaysia, being a net exporter of oil, to benefit from higher oil prices; as export earnings from crude oil contribute about 3.3% of total gross exports in 2001. Meanwhile, in terms of gold, Malaysia's demand curve for gold is generally elastic. Therefore, any increase in the price of gold will result in a decline in demand. However, the effects on the countries' growth rate cannot be easily conferred because the

effect has been complicated by other important events and changing economic conditions during the period in which the oil shocks occurred.

1.2 Objective of Study

The objective of this paper is to determine the effect of a global oil price and gold price shock on the growth rate of Malaysia as compared to the US for the period of 1970 to 2002. The reason these two countries were used is to enable the comparison between a developing country and a developed country, as well as the comparison between an oil-producing country and oil-importing country.

The study focuses on the application vector autoregression (VAR) to assess the dynamic impact of oil and gold price shocks. By determining the relationship between the two commodities and the GDP in Malaysia, this shall benefit policy-makers in conducting policy, be it monetary or trade policy. The factors attributed to commodity price shocks and the implications of global oil price shocks on the economy is also discussed.

1.3 Statistical Program

The statistical software program – Econometric View (EViews) 3.1 is used for analyzing the data.

1.4 Organization of Study

In this paper, there are 6 chapters altogether. Chapter 1 gives the introduction, the objective of the study, the statistical software used to conduct the research.

Chapter 2 presents a vast literature on the subject. Firstly, we look at the effect of a rise in commodity prices on the growth rate. Then, regarding the crude oil shocks, we explore the relationship between oil price shocks and GDP, the effect of oil price shocks on the GDP, the magnitude of such shock and transmission mechanism involved, and also the role of monetary policy in the oil-GDP relationship. On the gold price shocks, we shall look at a studies on the gold prices, more specifically, the few studies on the gold prices such as the gold standard, the arguments for and against the gold standard, its effects on the economy and implications of a gold price shock.

Chapter 3 will cover a brief history and price analysis for the crude oil and gold. Firstly, the interlink between gold prices and oil prices in the past is examined. Then, each commodity is explored on its own; looking at each individual history and analyzing its price development. For the gold commodity, we shall look at the history of gold price shocks since the gold standard period until the flexible exchange system period; while for the crude oil commodity, we run through the three main oil price shocks. Lastly, a brief record of the Malaysian economy history is presented.

Moving on to Chapter 4, an explanation on the data and methodology in conducting this research is detailed out. In this paper, I shall use the Vector Autoregression (VAR) and the Impulse Response Function (IFR) to determine the dynamic relationship between the GDP and oil price and gold price shocks.

Finally, the results and conclusion will be laid out in the chapter 5 and 6 respectively. There is also a discussion on factors affecting commodity prices and the impact of high oil prices on the economy in Chapter 6.