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The relationship between inflation and economic growth in Vietnam

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Abstract

The relationship between inflation and growth has attracted economist's concerns. Contemporary studies indicated a nonlinear and complicated relationship that inflation could bring positive or negative impact to economic growth depends on different conditions, of which, productivity is an important one. Vietnam faced 2 digits inflation rate in early 1990s and in period of 2010 – 2011 that caused macroeconomic instability. In general, the relationship between inflation and growth in Vietnam has a complicated movement with negative relationship in some period of time and or negative one for other time. One of the most important conditions that have affected inflation and growth's correlation in Vietnam is productivity. The changes in productivity in Vietnam has impact to the inflation – growth relationship in way of whether the overall productivity creating space for growth or not, along with inflation movement. Therefore, to control inflation – growth relationship, improving the overall productivity is the key strategy for Vietnam.

Keywords: *Inflation, Economic growth, Productivity, Vietnam*

Introduction

Facing high inflation has been an experience in Vietnam. The economy had to underwent 2 digits inflation several years. Along with inflation fluctuation, Vietnam economic growth has varied year by year. Studying the relationship between inflation and economic growth should recognize the decisive impact of a country's production capacity that is a necessary condition, which determines space for growth. When production capacity has reached a limit in terms of resources and a certain pattern of growth, the space will be so small that higher inflation is no longer a "catalyst" for growth, it leads to economic uncertainties that has a negative impact on economic growth. Therefore, studying the relationship between inflation and the growth of an economy should put in certain conditions the production capacity as well as the macroeconomic policies manipulation of the government to capture the whole picture of Vietnam economy.

Methods & Materials:

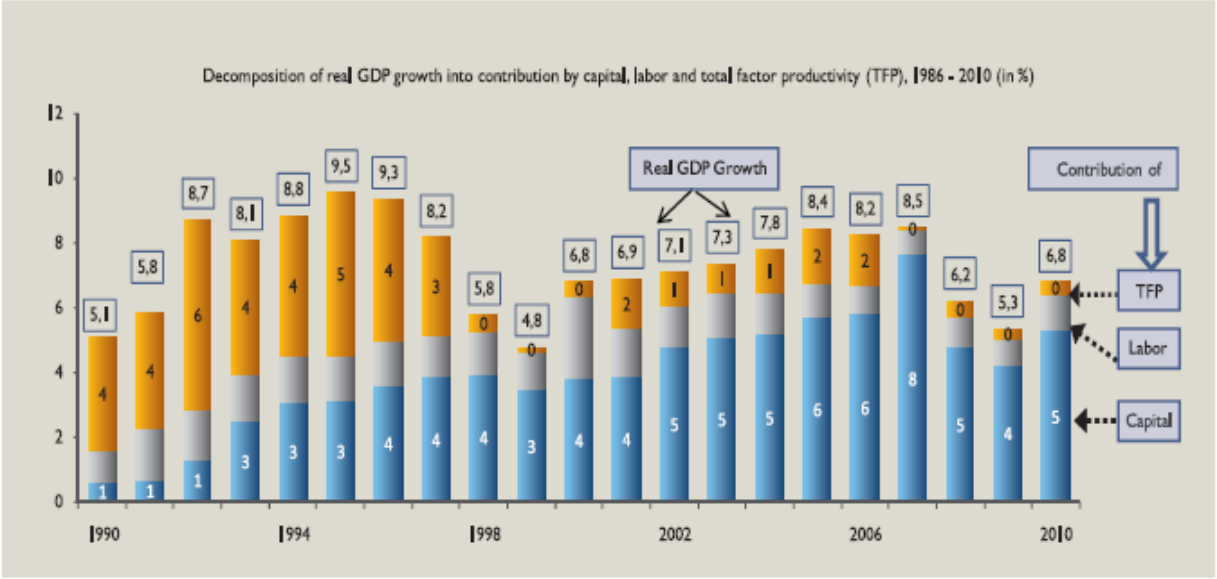
The study has been based on empirical observation available from different reports, various journals, and e-journal. Collection of available literature, detection of situation in the

place of importance was gathered through personal observations and, collection of related information's. The nature of the present research work is explorative and the whole work has been done by descriptive as well as analytical methods.

1. The relationship between inflation and growth in condition of changing overall productivity in Vietnam

After 30 years of implementing the "Doi moi"[1] policy, Vietnam has reached comprehensive improvements with remarkable achievements. Besides, the international economic integration process has also led to increasing foreign capital inflows to Vietnam that has sparked significant changes in the manufacturing sectors. As a result, Vietnam's GDP increases continuously over the years, from 140 USD/person/year in 1992 increased 13 times to 1,908 USD/ person/year in 2013.

However, there have been signs of downward trend in productivity (Fig.1). Along with this change in productivity, inflation fluctuation also affect to the economic growth but not in the same trajectory.



Sources: CIEM (2010).
Note: The estimates for 2009 and 2010 are done by the World Bank.

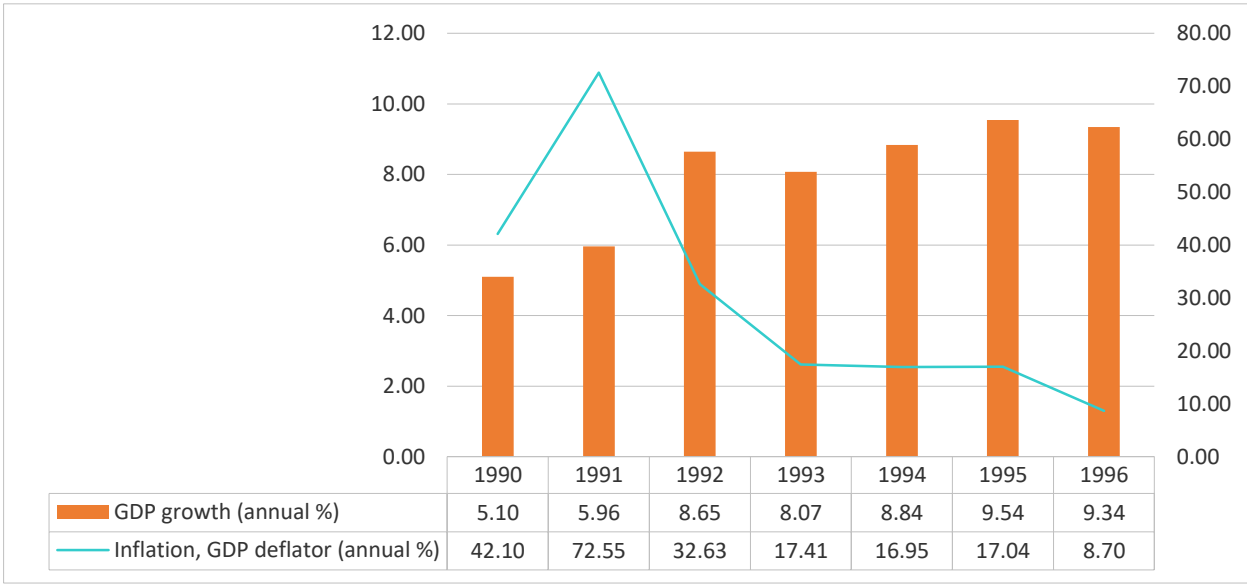
Figure 1. Decomposition of Growth into contribution by Capital, labour and TFP

(1990 – 2010)

[1] An economic reforms initiated in 1986 to transfer Vietnam economy from centrally planned economy to market oriented economy

The movement of inflation and economic growth in Vietnam can be divided into four phases with variations in terms of production capacity as well as in macroeconomic stability.

- ***The period of 1990 – 1996***



	1990	1991	1992	1993	1994	1995	1996
GDP growth (annual %)	5.10	5.96	8.65	8.07	8.84	9.54	9.34
Inflation, GDP deflator (annual %)	42.10	72.55	32.63	17.41	16.95	17.04	8.70

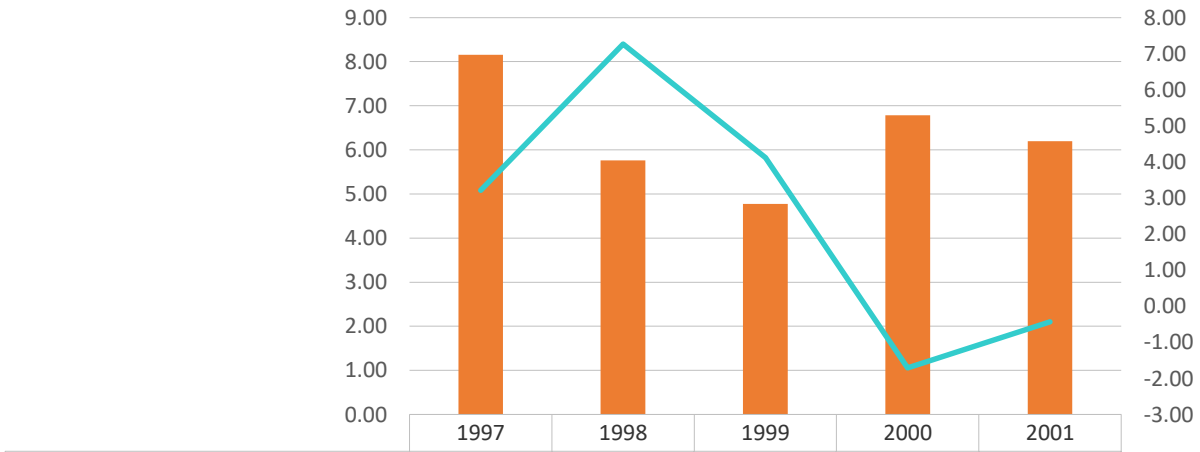
Source. World Bank

Figure 2. Inflation and GDP growth in 1990 - 1996

This period of time witnessed a negative relationship between inflation and growth. At the first 3 years, there was hyperinflation along with low GDP growth rate. Hyperinflation was under strictly control through fiscal and monetary tightening policies, thus, inflation declined rapidly, was 8.7% in 1996. Vietnam economy became more and more stable with lower inflation, setting a good condition for economic growth. The GDP growth rate increased to 9.34% in 1996 from 5.1% in 1990.

Remarkably, although both fiscal and monetary policies were manipulated with a tightening direction aimed at stabilizing the inflation. However, the economy didn't have to pay the growth as a tradeoff. In contrast, because Vietnam was at the ideal stage of reforming by "Doi moi" policy, the economy was restructured and comprehensively renovated that created room for economic growth, Vietnam GDP growth rate has improved and has reached an ideal level of 8,89%/year in average after inflation being controlled.

➢ ***<u>The period of 1997 – 2001</u>***



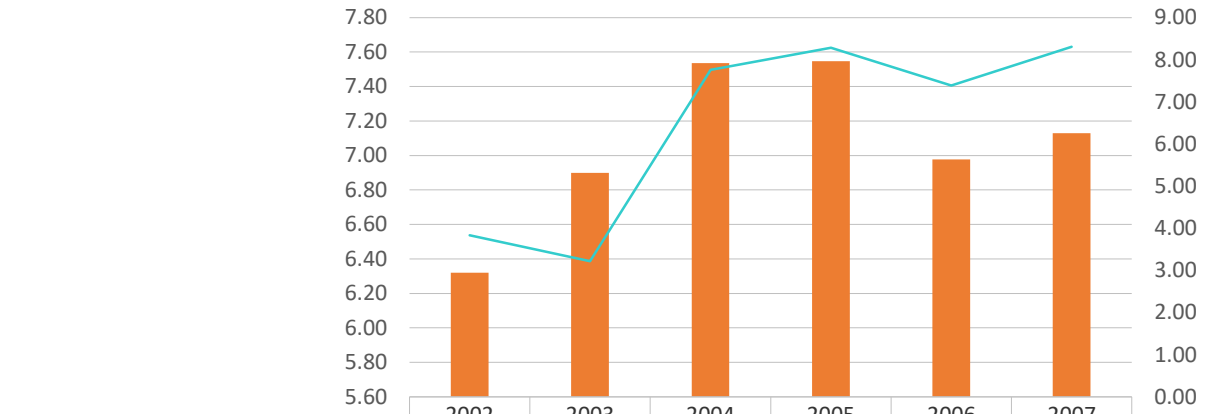
	1997	1998	1999	2000	2001
GDP growth (annual %)	8.15	5.76	4.77	6.79	6.19
Inflation, consumer prices (annual %)	3.21	7.27	4.12	-1.71	-0.43

Source. World Bank

Figure 3. Inflation and GDP growth in 1997 – 2001

Similar to the period of 1990 -1997, this period of time also witnessed a negative relationship between inflation and growth, but in opposite trend. After hyperinflation stage, the period of 1997 - 2001 remarked a deflation stage in Vietnam that caused by the Asian financial crisis. The complex fluctuations of the regional economy and the resilience of deflation had a negative impact on Vietnam's economic growth, with average economic growth rate falling sharply from 7.93% in the previous period to 6.33% during this period, the lowest economic growth rate was 4.77% in 1999.

➢ ***<u>The period of 2002 - 2006</u>***



	2002	2003	2004	2005	2006	2007
GDP growth (annual %)	6.32	6.90	7.54	7.55	6.98	7.13
Inflation, consumer prices (annual %)	3.83	3.22	7.76	8.28	7.39	8.30

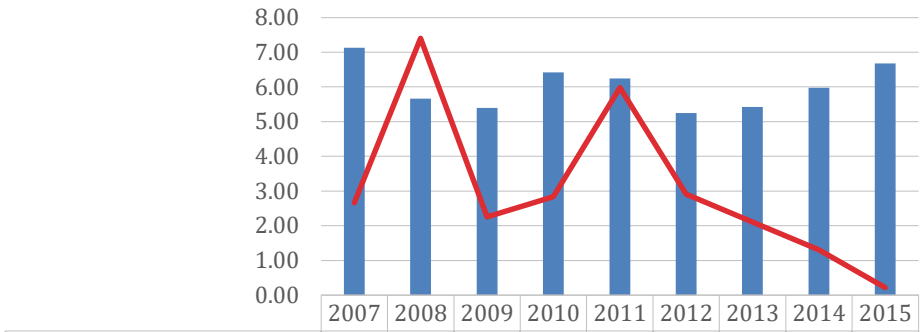
Source. World Bank

Figure 4. Inflation and GDP growth rate in 2002 - 2007

Opposite to the previous stages, the relationship between inflation and growth in Vietnam had a positive trend. Deflation in Vietnam had been eliminated gradually by "demand stimulated policy" with the increasing in Government spending and enterprise Investment. Since 2004, inflation had risen sharply, from 3-4% in 2002, 2003 to 7-8% in 2004 - 2007. It is noteworthy that inflation accelerated in 2004 (7.76%) resulting in a growth rate of 5-6% over the five years (1998-2003) to 7.55%.

Looking at the whole of the period 2002-2007, the economy tended to increase capital for growth, fiscal and monetary policies were expanding exponentially. At the same time, the level of inflation under 10% control over these years created good environment for economic growth under the continued production capacity improving. Besides, the development of the stock market since 2005 with rapid expansion in scale, contributed to the development of a new capital mobilization and transfer channel that supported Vietnam production capacity led to higher contribution to the GDP of TFP in comparison with the period of 1997-2001 (Fig.1).

➢ ***From 2007 until now***



	2007	2008	2009	2010	2011	2012	2013	2014	2015
GDP growth (annual %)	7.13	5.66	5.40	6.42	6.24	5.25	5.42	5.98	6.68
Inflation, GDP deflator (annual %)	8.30	23.12	7.05	8.86	18.68	9.09	6.59	4.09	0.68

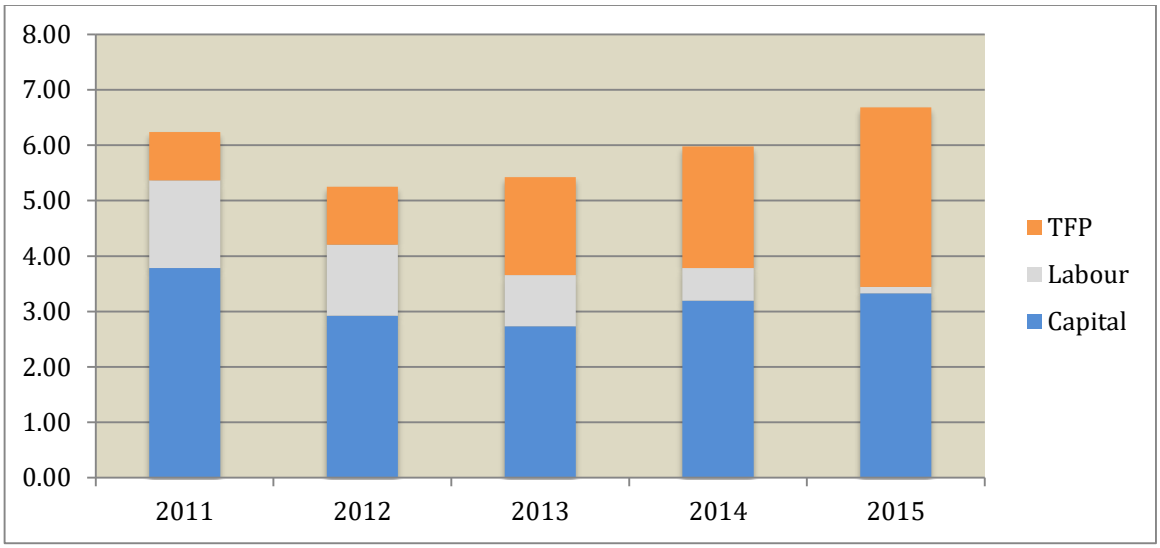
Source. World Bank

Figure 5. Inflation and GDP growth rate from 2007 - 2015

The 2007 period has witnessed a period of complex fluctuations in inflation with large distance - the highest inflation rate was 22.67% in 2008, while the lowest was 4.09% in 2014.

During 2007-2011: Inflation and growth fluctuated complicatedly with unspecified relationship due to the impact of the Global financial crisis. To deal with the adverse impact of the crisis, fiscal policy and monetary policy were implemented in expansionary term from 2009 to 2011 caused high inflation stage in Vietnam, however, the decline in growth rate was repelled not to fall deeply. Despite of this, the Government budget faced large deficit of 13% of GDP in 2010, far exceeding the safe level of 5% of GDP recommended by the IMF. In addition, the expression about limitation of production capacity began to emerge more clearly since 2007. The TFP's contribution to economic growth has fallen by 0.87%, the growth was largely due to the increase in capital investment.

Since 2012, the inflation – economic growth relationship has returned to the orbit that increasing growth rate was in companion with decreasing inflation rate. With the goal of stabilizing the macro economy, Vietnam Government has made significant reforms with the economic restructuring policy, concentrated on banking system and state owned enterprises. This policy has brought a good sign to Vietnam's productivity, the TFP growth rate has increased continuously since 2012 and the contribution of TFP in GDP rose from 0.87% (2011) to 3.24% (2015).



Source. Vietnam national productivity Institute

Figure 6. Decomposition of Growth into contribution by Capital, labour and TFP (2011-2015)

With the improvement in productivities, Vietnam's economic has a new room for sustainable growth from the year of 2012. The GDP growth rate has recovered gradually, reached 6,68% in 2015 along with the declining inflation rate. It is noteworthy that with this current stage of reform, Vietnam's inflation rate has been much lower than previous time and the economic recovery also seems slow. The restructure policy's effectiveness needs more time to verify.

1. Policy implication

A number of recommendations have been proposed from the study aimed at harmonizing the objectives of economic growth and stabilizing inflation as follows:

- Continue to restructure the economy and transform economic growth model to increase production capacity, create room for macro policies towards sustainable growth.

- Strengthen fiscal discipline of Vietnamese Government's revenues and expenditures in order to minimize the negative impacts of budget deficit to economic stability, growth and inflation. Control the budget deficit below 5% of GDP.

- Consolidate and strengthening the coordination of macroeconomic policies, especially the triad of policy: fiscal policy, monetary policy and exchange rate to bring about synchronized solutions, improve the efficiency of macro management.

Conclusion

Study the relationship between inflation and economic growth in the context of the state of financial stability and production capacity of the economy, giving an overview of macroeconomic management toward growth and stability. To control inflation and motivate sustainable growth,

improving the overall productivity is the key strategy for Vietnam, the Restructure policies that has been implementing since 2011 is considered as a new "Doi moi" policy. Hopefully, with appropriate steps and commitment from Vietnam Government to restructure the economy, Vietnam will have a new stage of stable inflation along with sustainable growth.

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