Is Inflation the Price for Economic Growth?

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1. Relation between inflation and economic growth

High growth rate, low inflation rate, low unemployment rate and favorable balance of payments constitute an ideal state for all countries. There are close relations between these factors, and especially between inflation and growth.

Many researchers have soon concluded that a high growth rate kept the inflation rate low and a low growth rate took place when deflation or hyperinflation existed. They agree that there is a close relation between the inflation and growth rate, but how close this relation is still causes controversy. Research results of S. Fischer (1993) and M. Sarel (1996) show that the inflation and economic growth don't always run parallel; and the inflation can affect negatively the economic growth when it is higher than a certain level. The relation between the inflation and economic growth is non-linear. This means that with a low inflation rate, they are covariant, and become contravariant when the inflation rate is high. Different studies, including the most recent one by M.S. Khan (2005), have tried to establish the law of relation between the inflation rate and economic growth, and Khan established a limit of the inflation. When the inflation rate exceeds this limit, it produces negative effects on the economic growth: this limit in industrial countries is from 1% to 4% and from 11% to 12% in developing countries.

All economic authorities know that two important objectives for the monetary policy are: a high and sustainable growth rate, and a low and stable level of market prices, but most countries have to accept some trade-off between stabilized price level and economic growth. In these countries, inflation and economic growth always run parallel. In economies where the economy is run smoothly, infrastructure and facilities are good, monetary and budget policies are well linked together, administrative machinery operates well, competition is fair, banking service is effective and transparent and within the reach of most people, and investments from both foreign and local sources gain high efficiency that reflects itself in a low ICOR, the growth rate is higher than the inflation rate, and vice versa.

To make the use of the relation between inflation and economic growth, some countries intentionally let the inflation rate go high to accelerate the economic growth. Foreign experience, however, shows that, this practice can generate a fast growth but it is not sustainable.

To avoid such a situation, developed economies tend to gain some economic growth by keeping market prices stably at a low level. Grounds for such an approach come from a simple fact that the ability to make predictions is higher when the inflation rate is stable. This situation allows investors to develop effective investment portfolio and makes consumers feel more assured because they need not find alternative goods when prices go high. These advantages help promote the economic growth substantially.

Developed countries today believe that an inflation rate of 2% or 3% is an optimal condition for a sustainable growth. However, we need an overall view because a stable inflation rate is only an sufficient condition for a sustainable growth and the necessary condition is a right policy to develop resources, capital, and technology, etc.

2. Inflation and economic growth in Vietnam in the past decades

The question for Vietnam is what its optimal inflation rate is. The following table shows its inflation and growth rates in 1996-2007

Table 1: Vietnam's inflation and growth rates in 1996-2007 (%)

Year	Inflation rate	Growth rate
1996	4.5	9.34
1997	3.6	8.15
1998	9.2	5.76
1999	0.1	4.77
2000	-0.6	6.79
2001	0.8	6.84
2002	4.0	7.04
2003	3.0	7.24
2004	9.5	7.67
2005	8.4	8.40
2006	6.6	8.20
2007	12.6	8.50

Source: General Bureau of Statistics

The data show that the inflation control in 1996-97 was done well when the two-digit rate in previous years was reduced, but the growth rate also fell after a period of good development.

In 1998, the inflation rate rose to 9.2% because of effects of the Asian monetary crisis 1997. The crisis reduced the growth rates of many countries in the region, along with cyclical recession of the world economy, and Vietnam suffered a state of deflation with the result that its inflation rate fell to 0.1% in 1999 and its growth rate fell to 4.77% - the lowest level since 1990. In 2000, Vietnam still suffered some deflation with an inflation rate of 0.1% but it showed signs of recovery in a growth rate of 6.79%.

In the next years, the inflation rate ran parallel with the growth rate and reached the peak of 9.5% in 2004 while the growth rate rose to 7.7%. In 2005 the inflation rate fell to 8.4% equaling the growth rate. This year also witnessed the highest growth rate after the Asian monetary crisis. In 2006, the inflation rate fell to 6.6%, lower than the growth rate but it rose to a record level of 12.6% while the growth rate was only 8.5%.

Thus, the data show that effects of the inflation rate didn't take place according to some law. Comparing data over years, however, allows us to conclude that very high or very low inflation rate usually runs parallel with a low growth rate while a higher growth rate can be gained in years when the inflation rate is moderate, from 3% to 5%.

The data also show that an inflation rate that is higher than the growth rate is not a threat but it has become a reality. When the growth rate is high, the inflation rate is also high, but a very high inflation rate may destroy results of a high growth rate. It's about time authorities had to choose between those two objectives.

The high inflation rate in 2007 provides us with a precious lesson about the quality of economic growth. There is a close relation between the two factors, and what we should do and hope to gain is a growth rate that is higher than the inflation rate. The economic growth must be linked with its quality and it is what we should pay full attention to instead of quantitative results.

The inflation reflects shortcomings in the state's management at macroeconomic level, which affects seriously the living standard. The inflation must be employed as a stimulus for economic development and better quality of the growth. This approach requires great skills, otherwise the quality of the economic growth will go from bad to worse.

In such a country as Vietnam in its integration into the world market, high growth rates can help attract foreign investment needed for the building of the infrastructure and future development. But it doesn't mean that we should accept an inflation rate higher than the growth rate, therefore, the Government should take appropriate measures to adjust macroeconomic objectives.

3. Things should be done to ensure sustainable development

Importantly, the Government should know what it wants and what it aims at for the year in order to work out directions and measures. With two parallel targets – high growth rate and low inflation rate – it should accept some trade-off between them because they are not always achieved without difficulties.

The year 2008 should be considered as a special year when prices of many essential goods are allowed to float, that is, they are decided by the 'invisible hand' without government's intervention. Under such conditions, Vietnam must accept the inflation to a certain extent, and then, strong measures are taken to curb it. It is also a special year because one of its most important tasks is to stabilize the macroeconomic management. There are two problems for the Government:

(1) Objectives of stabilization of macroeconomic management and economic growth should be made clearer. When the macroeconomic management is stabilized, it is not difficult to gain a growth rate of 8%.

(2) If the present growth rate is maintained without the stabilization of the macroeconomic management, many risks in social life and management will become more serious. High inflation rates make it difficult for investors to work out their long-term investment plans, and as a result, they tend speculate in fields that do not produce much added value or new production capacity. This situation is visible on the realty market nowadays.

Thus, the following urgent measures must be taken to stabilize the macroeconomic management:

- Increasing the supply of goods and services to ensure a balanced relation between them: To achieve this aim, it's necessary to pay attention to three parties. The first one is local producers. The government should take precautionary measures to fight epidemic and natural disaster in order to minimize losses, and encourage production of alternative goods (for meat of cattle and poultry for example). The second one includes major suppliers of goods. Inspections must be carried out regularly in order to prevent them from keeping goods in warehouses in wait for higher prices, and punish speculators in essential goods. The third one is importers. Import could be promoted for the time being to increase the supply of goods.

- One direct and important measure at present is to withdraw money from the market to banks. Such measures introduced by the SBV as a higher required reserve ratio, a 3% limit of credit supplied to investors in the stock market are rather late but they are effective and necessary. Other measures could be taken are: issuing bonds, and raising the deposit rate, etc. Commercial banks had better accept lower profits, and even some losses, for the time being, in order to stop the inflationary spiral. The Ministry of Finance can issue T-bonds and T-bills through the open market to withdraw the money from circulation. The SBV had better avoid issuing its own bills in order to save itself from becoming a debtor to commercial banks. Moreover, this is only a shotgun solution, not a common one.

- Improving the investment climate to mobilize enough capital for economic growth: Full attention must be paid to improvements in the use of investment, especially the public one. Projects that are carried out too slowly or designed poorly or unnecessary could be cancelled or revoked.

- Carrying out the tight-money policy flexibly and actively: Public expenditure must be restricted, efficiency of the use of public funds must be enhanced, budget deficit must be reduced, and policies on foreign trade, salary and investment must be implemented properly. Generally, all policies must be linked together and well coordinated in order to ensure the best results.

- Credit, monetary and financial policies introduced by the Government and the SBV should keep on creating conditions for healthy development of the realty market. Speculation in real estate could be prevented by a strict control over the credit supply, taxes and other administrative measures.

- Perfecting the plan on a sustainable and stable development for the stock market: All necessary measures must be taken to prevent the stock market from collapsing and help them recover, encourage the supply of commodities, and remove limit on number of companies that want to list on the trading floor ■

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