Inflation and Risk Precaution

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In the globalized economy, fluctuations in some sensitive goods, such as oil, steel, gold and hard currencies, are common. One of measures to control these fluctuations for the state and private persons is to use instruments for determining expected prices of factor inputs. This measure also has its price that is inevitable in the integration process.

1. Recent changes in the domestic market

The public have recently witnessed many shocking changes that spread from the world market. The first one is the two-digit inflation rate in the first 10 months of 2004. It was followed by the fall of the U.S. dollar against other hard currencies, and pressure from the G7 on China to float its currency. These changes made exports from Vietnam less competitive on the world market. Moreover, foreign tourists could find that tours to China or Thailand are cheaper in comparison with ones to Vietnam.

Are they abnormal phenomena? Maybe they are. But from other viewpoints they seem normal things in a globalized economy. Looking back on events in the past few years we could agree with this remark. Shocking events take place at any time and anywhere.

In the years 1999-2000 the whole world held its breath as the Fed allowed the interest rate to skyrocket in an effort to deal with the hot development of the economy. And as a result, finance markets all over the world underwent wide fluctuations, including the newly established one in Vietnam. At that time when the interest rate on the dollar rose, the discount rate reached 6.5% a year making stock indexes fell continuously. The second fact was the drastic fall of the dollar since 2001, which made the gold price skyrocket. These shocking events made the oil price fluctuate widely in the few decades.

In the near future when the control over the exchange rate is less strict, local companies engaging in international trade will face the exchange risk. Unpredictable changes in the exchange rate in recent years show that the central bank has operate its exchange control according to changes in market forces. Most local companies have paid more attention to the exchange rate to the dollar and many of them are afraid of possible falls of the domestic currency, which could make imports dearer and affect badly on the inflation. This means that both business risk and inflation could be higher when Vietnam integrates into the world market.

As for producers of goods for domestic market, they also face the risk caused by the economic exposure when the dollar falls against the domestic currency, which makes imports cheaper than locally-made goods.

2. The need to determine estimated prices when making business strategies

Besides such disasters as the bird flu, crises caused by economic depression, terrorism and wars all over the world in recent years lead to a question: Should we find a way to live with and survive fluctuations and shocking events? The answer is yes. And one of measure taken by governments and companies is to take precaution against risk when making their macroeconomic policies and business plans.

The macroeconomic policy in Vietnam is usually made subjectively and the Government never asks ministries to determine prices of factor inputs by employing precautionary instruments, which forces ministry to adjust the planned targets continuously. For example, the Ministry of Finance had to adjust the planned budget income from export of farm products because their prices fluctuated widely last year. This situation will certainly af-

fect the task of keeping the budget deficit under 5% of the GDP as required by the National Assembly. In 2004 when the inflation reached the two-digit level, the National Assembly planned to refrain from determining the inflation rate of 4% that the Government should meet. Is it a sign of confusion when making the policy? How could investors and the public in general estimate different variables when making decisions on investment without the predicted inflation rate? As for foreign investors, how can they want to do business in Vietnam when they don't know how determined the Government is to control the inflation?

3. A need for perfect and diverse precautionary instruments

One of commodities the financial market in Vietnam failed to supply is derivative that could be seen an additional precautionary instrument for investors to concentrate more energy on their business. At present, there are also some instruments offered by the market, such as forwards, swaps, options, etc. but they exist almost on paper only and few companies employ them. More alarmingly, some commercial banks pay almost no attention to these instruments. Is it true that they are not necessary, or banks don't know how to employ them, or they are not perfect because of barriers raised by the central bank? Perhaps the answer is yes.

Maybe policy makers didn't allow them to be employed broadly because they are afraid of negative effects of these instruments. In the swap service for example, users face some unreasonable regulations. A company that want to avoid risk decides to exchange EUR80,000 for US$100,000 and use it for its business. When it wants to exchange the dollar for the euro, it is required to produce documents about the use of the sum of dollar. Such regulations also prevent companies from assessing the overheads.

4. What should be done?

To control possible fluctuations in the future, both the Government and companies must reform their way of making policies and strategies.

All individuals and companies should consider taking precautions as a must instead of taking measures only after some bad happenings. Precautionary instruments such as options are very appropriate for the changeable world of the present. It's time for companies to establish departments for employing these instruments when doing their business in order to avoid losses when shocking events take place.

Combination of options on such commodities as money, gold and steel is very diverse. They allow local companies to secure buying prices and take opportunity when appropriate. Of course, options also could be speculated, which in its turn could make the inflation rate rise and business circle lost their confidence in the exchange rate system. This is, however, an inevitable happening in the market economy and it mustn't be seen as an excuse for banning them. Moreover, there is no evidence that the speculation in options or other commodities leads to an exchange rate or economic crisis. Stability of the exchange rate or market prices relies mainly on the stability of the macroeconomic policy. However, in our opinion, the trade in option could be introduced step by step to Vietnam.

At a macroeconomic level, the Government had better develop a policy to ensure energy security. One of instruments for controlling risks caused by rises in the fuel price is to use future contracts. It could help the Government control many variables, especially the oil price, thereby working out other long-term targets.

It is about time the central bank allowed commercial banks to offer other precautionary instruments suitable to local conditions, such as options based on the domestic currency. This measure is the best way to help the public get access to precautionary instruments and encourage them to make their own decision instead of relying too much on the government intervention when unfavorable changes take place. These efforts could help turn the domestic currency into a convertible one.

Thus, fluctuations in prices of sensitive goods are common in the globalized economy. The problem for governments and companies as well is to take precautionary measures to determine the price of factor inputs when making long-term strategies. Of course, these measures are also costly but the cost is always small in comparison with benefits they bring about.■