THE PHENOMENON "DEFLATION - DECREASING INTEREST RATES - DECLINING ECONOMIC GROWTH" AND SOME PROPOSALS TO BOOST UP THE ECONOMIC GROWTH

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I. PROBLEMS TO BE SOLVED IN THEORY

In the three recent years, our economy has attained high growth rates (GDP increased by over 8%/year on average, industrial output up by 12%/year, food output up by 1 million tonnes/year). The inflation dropped (95: 13%; 96: 10% (estimated), the foreign investment is on the rise.

In the early 96, all of us thought that the economy would keep on operating in the above trend, and one of the greatest concerns is to curb inflation under 10%. However, in the first eight months of this year, an event which hadn't been seen in the past 20 years has taken shape: In the successive 4 months (from June to August 1996), the consumer price indexes are negative figures, and the inflation rate compared with December 1995 is only 2.2%. If this trend goes on until the year's end, then the inflation rate of 1996 will be between 0 and 1%. If the recent inflation rates of the US, Japan, Germany are between 1 and 3%/year, Vietnam's inflation rate of 1% is not problematic. But Vietnam's deflation was accomplied with some bad signs of the economy as follows:

- The growth rate is on the fall, lower than expected. In the last eight months, HCMC's industrial output increased only by 5%, while the year's plan is 15%.
- While enterprises usually "cry" for investment capital, the lending interest rates went down continually (lending interest rates for short-term loans reduced to 1.4% from 1.7%/month, and the money glut in banks is increasing).
- Many businesses have to reduce production due to their stockpiled products. According to reports, enterprises sold only one-third of their products.

Furthermore, a "new mechanism" in Vietnam's trade activities has lately come into being: it's the increase in buying foreign goods by deferred payment on large scale and selling them with/without installments. From the aspect of economic management, the question is why the economic development went down and how to overcome that situation. In other words, we should explain why there was the phenomenon "deflation-decreasing interest rates - declining economic growth". Due to interactive economic events, the search for causes of an event is sometimes complicated. In order to surpass this difficulty, we choose the method that we should reach a concensus on basic economic mechanisms (the causalities of specific, individual economic events), then analyze the economy on the basis of identifying basic economic mechanisms and institute the relationship betwen them.

II. BASIC ECONOMIC MECHANISMS

To deal with the phenomenon "deflation-decreasing interest rates - declining economic growth" (3 decreases in short), we should come to one mind about the following five kinds of basic economic mechanisms.

1. Why did the prices drop?

In the market mechanism, when prices are determined by supply-demand relation, the market prices drop due to two causes: decreasing demand or increasing supply. The demand lowers because of four main reasons: the government's policy on limited export, the decreasing population's incomes (regarding popular consumer goods) or the declining enterprise's business performance, the decreasing utilization value of products (absolutely or relatively) due to the appearance of new products, and prices of other commodities fall (the purchase of new goods rises, so the individual budget for the mentioned goods decreases). The "decreasing demand" of the mechanism of lowering price is presented by the chart 1

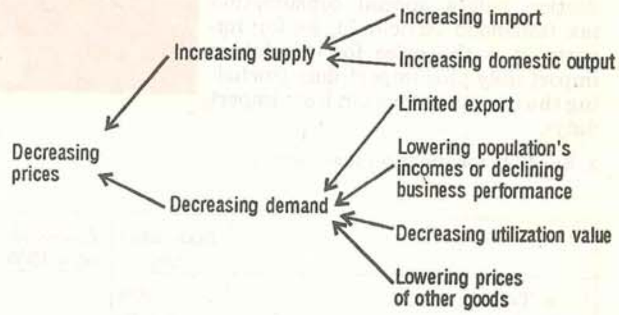

Chart 1: the basic economic mechanism 'decreasing prices'

2. Why did the import rise?

There are three direct causes of increase in import: The real exchange rate drops (our currency value rises against foreign one), domestic need for imported goods increases and policies on stimulation of import. In three recent years, the norminal exchange rate of Vietnamese đồng was almost unchanged, about VNĐ 11,000 to the US dollar. In that period, the inflation rate of Vietnamese đồng was 32% (in three years) and American inflation rate was 9.2%. Thus, the real exchange rate at the end of 1995 is equal to that of the beginning of 1993, the norminal exchange rate must be VNĐ13,300/US$. Since the Government still keeps the exchange rate at VNĐ11,000/US$, so in reality, the Vietnamese đồng increased by 17% from the beginning of 1993. The continual increase in the value of Vietnamese đồng is a strong incentive towards importers and limitation and losses towards exporters. Reducing import duty rates or extending import quotas are policies on stimulation of import of the host country. Importing goods on deferred payment is a policy on encouraging import from foreign entrepreneurs. So we have the basic economic mechanism "increasing import" shown in the chart 2

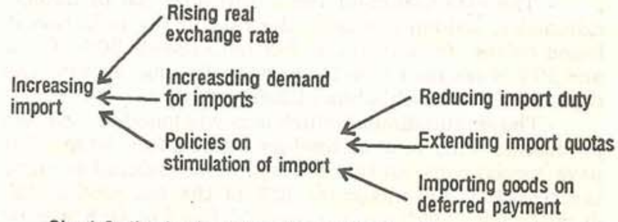

Chart 2: the basic economic mechanism 'Increasing import'

3. Why did the interest rates lower?

Basically, interest rates went down since the social demand for capital declined or the money glut in banks was so great. The enterprises' need for capital decreased due to the gloomy future of business (product prices down for example) or utilization of foreign capital (via investment cooperation or importing goods on deferred payment). So, we have the basic economic mechanism "decreasing interest rates" presented in the chart 3.

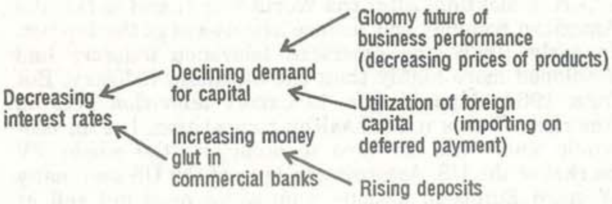

Chart 3: the basic economic mechanism 'Decreasing interest rates'

4. Why did the development of domestic production decline?

The input factors of production such as prices of materials, power, management skill, wages, taxes and output factors such as selling price of products, purchasing power, all affect production development. In this article, we would like to mention only the influences of output factor on the development of production. Firstly, if the selling price of products of a company lowers (due to competition) then the company cannot plan to expand production and if the market price is lower than the company's cost, then the company will go bankcrupt. If imported goods have higher quality and their prices are not higher than domestic ones of the same kind, they will cause some domestic enterprises' bankrupcy.

The market prices of products drop because the supply rises and imports increase drastically, or the purchasing power declines. The demand for goods goes down possibly because there are policies on limited export, incomes able to buy goods decrease, or the usefulness of product lowers (see the mechanism "decreasing prices", the chart 1). So, we have the basic economic mechanism "the development of domestic production declines" according to the chart 4.

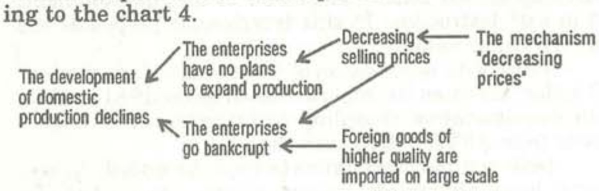

Chart 4 : the basic economic machanism:
Development of domestic production declines.

5. Why did the consumer price index lower (deflation)

As defined, the price index includes prices of some hundred or thousand of commodities with figures in accordance with the importance level or the budget share spent on that commodity. When the price index drops, certainly there are lowering prices of some products but prices of others can still increase at the same time. If we divide commodities into four groups: food and foodstuff; non-foodstuff goods; power and materials; and services, then we have the basic economic mechanism "decreasing price index" following the chart 5.

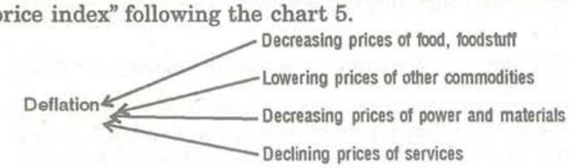

Chart 5: the basic economic mechanism 'deflation'

III. THE MODEL OF MECHANISM CAUSING THE PHENOMENON "DEFLATION - DECREASING INTEREST RATES - DECLINING ECONOMIC GROWTH"

Based on the five basic economic mechanisms mentioned above and Vietnam reality, we can put forward the mechanism model causing the phenomenon "3 decreases" according to the chart 6.

Firstly, an outstanding event in August: the import has boomed. Vietnam excessive import in this period was equivalent to 20% of GDP in 1995, while the normal figure is about 5%. The reason for import booming includes the effect of our decreasing real exchange rate during the past three years (box 1, chart 6) as well as bad effects of such recent policies as: buying foreign goods on deferred payment, extension of import quotas of 1995 to July 1996 towards many commodities, abolishment of quotas for non-strategic goods. At present above 400,000 tonnes of steel are stockpiled, many domestic steel mills and JVs have to reduce output, but the import quota of 1995 is still extended to mid-1996. The farmers growing sugarcane have suffered losses due to lowering price of sugarcane, however, some enterprises still import sugar. Over 15,000 tonnes of paper are kept in stock. So far, the value of imported goods on deferred payment amounts to VNĐ15,000 billion.

The import booming has created reaction on the three kinds of market: the booming market with imports (boxes 4, 4.1, 4.2, 4.3, in the chart 6), the market seeing no great changes in imports (box 5, 5.1, 5.2, 5.3, 5.4), and the capital market (boxes 6, 6.1, 6.2, 6.3, 6.3, 4.3 and 7). In addition, the operations of the food market and the export curbing effect of fixed exchange rate have influences on different stages of these three markets, lead to last results as deflation, lowering interest rates and declining economic growth (the chart 6).

We will examine more carefully each kind of markets and we may think there are no reason for decreasing prices in the market having no imports booming. However, because installment sales in the country (concerning highly valuable goods such as motorbike, television set, refrigerator, washing machine) are encouraged, remaining incomes of buyers for other expenses will reduce continuously for a long time (installments), therefore these people's purchasing power towards other commodities will decline (boxes 5, 5.1, 5.2). This leads to the downward trend of these markets' prices, declining production and decreasing demand for investment (boxes 5.3, 5.4, and 5.5). So, due to buying on deferred payment and installment sales, the market having no increase in imports also come to stagnation, contributing to deflation and declining economic growth of the whole society.

In the capital market, interest rates lower because of the pressure of capital supply and demand. Since the companies pay for goods they imported in 6 months or one year later, their proceeds from sales will be at once deposited in banks for interests. Therefore, short-term deposits boom. If one-third of imported goods were approximatedly sold, then the deposits amounted to VNĐ 5,000 billion. To settle these deposits, the banks are forced to reduce interest rates (boxes 6, 6.1,6.2). Regarding demand for capital, the cause of lowering interest rates derives from three sources. Firstly, domestic businesses reduce demand for investment due to the advantages of imported goods (boxes 4.1, 4.3, and 6.3). Secondly, domestic businesses which do not suffer losses due to imported goods still have to reduce demand for investment, because of declining purchasing power (boxes 5, 5.1, 5.2, 5.3, and 5.5). Thirdly, the demand for capital of businesses which bought foreign goods on deferred payment will go down drastically. As a result, the total demand for capital of the society drops (not to mention new JVs), interest rates certainly lower (boxes 4.3, 5.5, 7 and 6.3).

In the food market, the rice supply increased continuously in the past five years. However, the domestic need for rice did not rise fast and came to stability. Therefore, if the rice export do not increase (some two million tonnes per year), the amount of rice processed into industrial food do not increase, then the more the food output increases, the more the rice price decreases. That's theory and reality of Vietnam at present (boxes 8.1, 8.2, 8.3 and 8.4). Due to decreasing rice price, incomes of most of 50 million people residing in rural areas will lower, leading to their declining buying power. This also makes prices of other markets lower (boxes 8.5. 8.6, 4.1 and 5.3). The decrease in industrial production is more serious. The fall in rice price affects greatly deflation on the whole (boxes 8.4 and 10) because the rice price's coefficient is great in the calculation of price index.

At last, the curb on export, due to fixed exchange rate (Vietnam's inflation rate is 3.5 times higher than that of the US in the past three years), has reduced demand for investment in various economic sectors, contributing to the lowering in interest rates (boxes 1.2, 4.3, 5.5 and 6.3).

From the above analysis and the chart 6, we can come to conclusion about major causes of the phenomenon "3 decreases" as follows:

1.The value of Vietnamese đồng continuously rose in the past years.

2. Policies on stimulation of import: buying foreign goods on deferred payment, abolishing quotas for non-strategic goods and extending quotas for some strategic goods.

3. Food output increased continuously while the need for rice rose more slowly due to limits on rice export, the domestic need for rice is gradually stable and the processing of rice is still underdeveloped.

IV.SOME PROPOSALS TO BOOST UP ECONOMIC GROWTH

By analyzing and find out causes of the phenomenon "3 decreases", we can suggest two kinds of measures: Ones to settle major causes, and others to settle intermediary causes.

1. To devalue Vietnamese đồng value drastically in the next two years

Our target is the stimulation of export, but our policies maintain the fixed foreign exchange rate (while our inflation rate is higher than that of the US). Therefore, import is encouraged and export suffers losses. If there had not been foreign investment in the five past years, then our policy on fixed foreign exchange rate would have made our economic growth less bright. It was said that Vietnamese đồng value should rise to enable the import of equipment, raw materials for production. This idea is not convincing because we can achieve this target via reduction of and exemption from import duty for preferential goods and at the same time we can also devalue Vietnamese đồng. Someone was afraid that drastical devaluation of Vietnamese đồng would cause economic unrest. The reality shows the deficit in the trade balance was widened and the economic growth declined due to fixed value of Vietnamese đồng against US dollar and this may lead to economic unrest. Besides, in the four years 1988-1992, we devalued the Vietnamese đồng to VNĐ10,500/US$ from VNĐ4,500/US$, that is, Vietnamese đồng was devalued by 133% within four years, an average of 33%/year. In those four years and from then to now, our economy have seen more and more stability. As compared with the beginning of 1993, Vietnamese đồng value has risen by 17%. The devaluation of Vietnamese đồng by 17% thus is not a risk. As compared with 1988, our economic management has more experience.

2. To put an end to uncontrolled import that may destroy domestic enterprises

The free, equal and healthy competition between domestic enterprises is a basic, long-lasting development dynamic of a market economy. But the free competition between domestic and foreign enterprises which is not controlled to speed up domestic production means destruction of domestic production. The following is a lesson of export demolition. After the World War II and so far, the American economy and science are always in the top list. In early 1960s, the American television industry had developed more highly than the Japanese industry. But from 1964, Japan began to export television sets to America. This is not a healthy competition, but an economic war, with the view to occupying the whole TV market of the US. According to laws of the US and many Western European nations, companies must not sell at prices under their costs in order to kill their rivals. However, Japanese companies, under the Government's direction via the Ministry of International Trade and Industry (MITI), quietly started a destructive competition in America. In 1965, a color TV set was sold at US$700 but its price in the American market was US$400. Obviously, American companies could not endure the destructive price. Within a short time, 6 big TV companies and many small ones had gone bankrupt and 70,000 people lost jobs. In 1964, Japanese TVs accounted for only 5% of TVs sold in America, this figure amounted to 50% in 1971 and until July 1995, the last TV company of the US had to stop its operations. The US, an economic and scientific power, have been wholy defeated by a small country in the "export war". The American TV industry eventually collapsed after 31 years (1964-1995) of operations due to uncontrolled import policies.

If our country does not put strict control over imports, domestic production sectors will be destroyed within a short time. As a result, the target of import - export management should be unified: import must serve the country's production development at first, then step by step improves the people's living. That does not mean to limit import, but import must aim at fast development, not at self destruction. In this trend, some proposals are put forward as follows:

- Along with devaluation of Vietnamese đồng against US dollar, tax rates for imports should be rectified at once, with discrimination according to categories and origins (goods from AFTA nations or others)
- Deferred payment imports must be ended, in one year at least, afterwards, import of these goods should be re-examined to grant quotas and impose proper tax rates in accordance with the target of import management.
- The current system of import quotas should be re-evaluated and newly established with the aim to serve the fast development.

3. To speed up export of rice and food processed from rice

As analyzed above, to lift up the food price, raise incomes of tens of million farmers, the rice demand must increase. The basic measure is to enhance export of rice and food processed from rice. In the long run, the ratio of animal husbandry, perennial growing and food processing in the countryside and the economy should be strengthened.

4. To increase money supply immediately, then adjust it to the economic growth.

Three proposed measures: to devalue Vietnames đồng against US$, to import what serve the fast development and to increase export of rice and food processed from rice are based on three major causes of the situation " 3 decreases" at present. However, before the fact that domestic production develops at low level, we can take the measures affecting middle causes of declining growth rate (the chart 6, boxeses 4.1, 4.2, 5.1, 5.2, 5.3, 5.4, and 5.5). By increasing money supply to raise the selling price of rice and workers' salaries and expenditures on investment of the Government as well, the social buying power will soar and this will stimulate the economy to develop. The money issue will certainly increase inflation, but currently, our economy is in the deflation stage, therefore, the real inflation will be lower. When the economy strengthens its growth rate, the money issue will reduce proportionately.

In the above part, we have tried to analyze the causes of the phenomenon "3 decreases", suggested measures to accelerate the economic growth. we cannot quantify those suggestions in detail (to increase the foreign exchange rate at what size, in what duration, how to change import duty rates, to increase money supply at what size and in what process). These questions will be answered by experts.■

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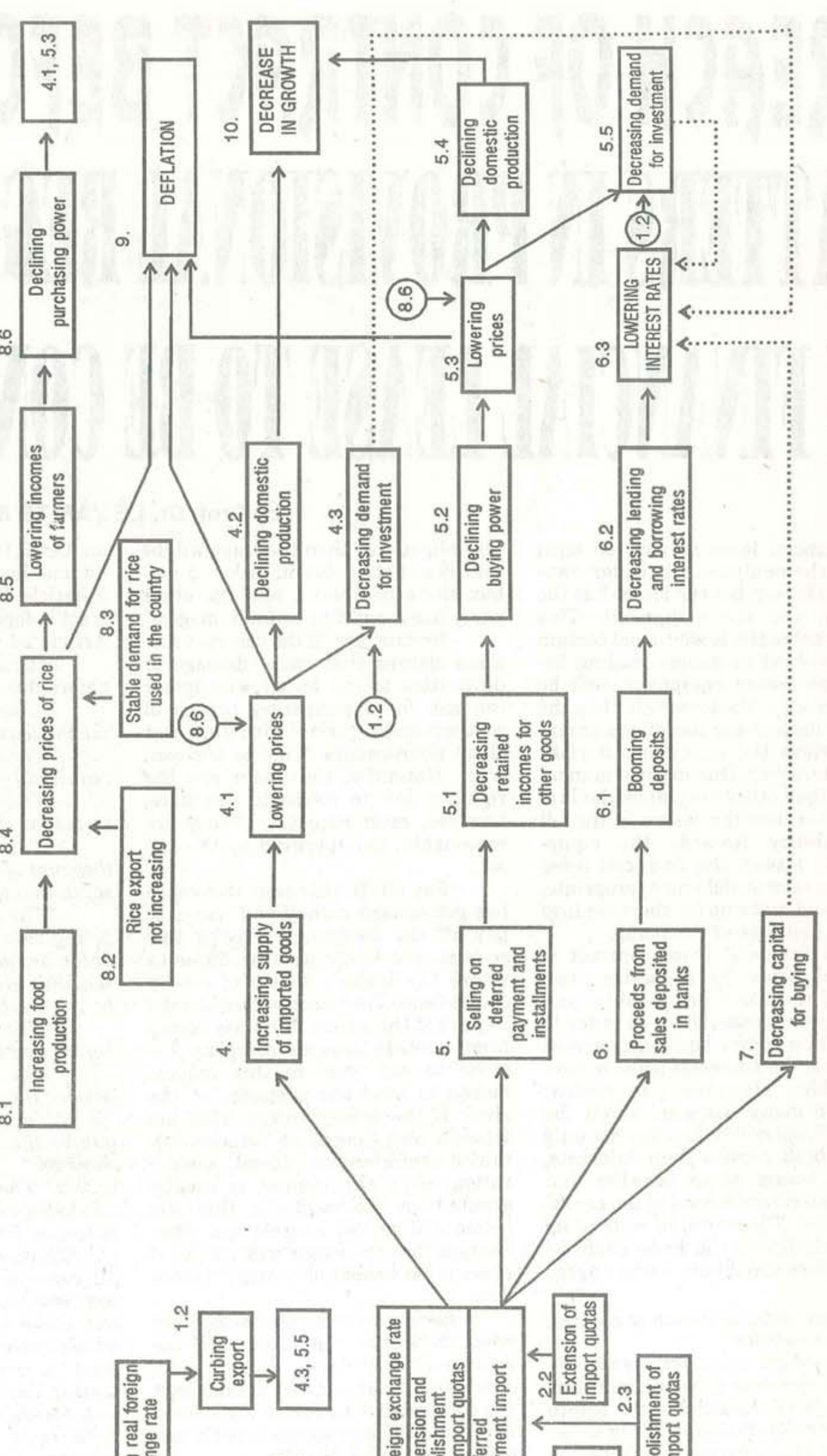

Chart 6: The mechanism causing the phenomenon "Deflation-Decreasing interest rates-Declining economic growth"