



# ON THE USE OF FINANCIAL INSTRUMENTS FOR CONTROLLING THE INFLATION

by Prof. Dr. DƯƠNG THỊ BÌNH MINH & Dr. VŨ THỊ MINH HẰNG

In Vietnam where the market economy is in its first stage of development, the inflation has become something inevitable because in this transitional period, the old mechanism is removed but not completely deleted while the new one has been just formed but not perfected. That is why some foreign experience and anti-inflation methods seemed useful and effective but they didn't produce intended results when applied to such an economy with poor infrastructure as Vietnam's. Therefore, looking for an effective method of fighting against, and then controlling, inflation suitable to the transitional period in Vietnam requires a lot of consideration. We know from experience that causes of inflation should be examined carefully

before solutions to this problem could be worked out. In the early 1980s, the leadership of the Government and VCP became aware of symptoms of inflation and tried to suppress it by supplying essential goods at low prices. Moreover, the failure to identify direct and principle causes of inflation and use financial instruments to control it made the struggle against inflation ineffective. In the late 1980s, when the economic reform was introduced and increases in bank circulation were recognized as the main cause of inflation in Vietnam, the Government decided to adopt a tight money policy in order to reduce the national budget deficit. Such financial instruments as interest rate and government credit were used for limiting increases in bank

circulation. The most remarkable result of this struggle was obtained in 1992 when the Government secured enough foreign and domestic loans to balance the national budget instead of issuing more bank notes.

The struggle against inflation in Vietnam showed that the pressure caused by budget deficit had been the main cause of inflation. Generally, the budget deficit is common in many countries, both developed and developing ones, but it is, for different reasons, particularly serious in Vietnam and what causes worry most is the fact that the budget deficit showed no sign of decrease in recent years although the inflation has been well under control. So the Government should make the best use of financial instruments in the coming years to make the public

finance sounder and control the inflation more effectively. To achieve this aim, in our opinion, the following problems should be solved properly.

(1) *Making the budget balanced and reforming the tax policy*

To deal with budget deficit, foreign governments usually secure loans from the public, money market, central bank and foreign counterparts. The proportions of these loans will affect differently the local economy.

In the coming years, the role of financial instruments should be enhanced. When using government credit, it's nec-

essary to maintain that the decisive role is always attached to the domestic source of finance while the foreign one is considered as an important factor in the economic development; and dependence on the foreign source of finance will lead to foreign capital surplus. The world economic history shows that no country could develop sustainably by using foreign capital. Japan and Germany are typical examples of development based on their own strength while Thailand and South American countries are painful lessons of the dependence on foreign capital. Foreign experience teaches us that we have to obtain at least one dollar before we can receive and use one dollar from abroad. As for loans from local money market, their size depends on the personal income and rate of saving.

The best way to make the national budget balanced is to increase its income and reduce expenditure. Applying the same tax system to all sectors has been considered as the initial result of the tax reform in Vietnam. According to many financial experts, however, the national budget income is still too small to cover all necessary expenditures. Thus, the question is how to reform the tax system with a view to increasing the budget income. However, increasing the budget income by increasing tax rates seems ineffective, and moreover, to cause social unrest. So the taxation machinery should be reformed radically in the coming years in order to make it more effective.

In reforming the tax system, full attention should be paid to not only increases in budget income, but also the effort to make the taxation a real instrument for encouraging production and regulating spending. At present, many taxes have come into effect (VAT, company income tax, excise duty, customs duties, etc.), however, the tax authorities should try hard to disseminate information about tax laws and make all necessary preparations for the enforcement of two new tax laws in order to make taxation a real regulating instrument.

Besides using financial instruments effectively, other supporting measures, such as regular inspection and auditing, should be taken to keep control over the national budget by thrifting and struggling against wastes and unnecessary expenditures. The Government had better make a detailed plan or strategy to establish the balance between foreign and domestic capital, and between employment of foreign loans and debt repayment, in order to avoid running into debt.

### (2) *Using financial instruments to control inflation*

We could say that adjustments to interest rate helped overcome the hyperinflation in 1989 and this fact showed us the importance of financial instruments to macroeconomic management.

To make the best use of these instruments in the coming years, we must be aware that the role of financial instruments should be appropriate to each stage of development. In the past when the inflation rate was very high, the use of strong measures to stop the hyper-inflation and reduce the inflation rate was necessary. At present, however, the economy has passed its crisis and become strong enough to control the inflation rate, so it isn't necessary to pay too much attention to monetary measures and the central bank had better only concentrate on the task of controlling the inflation. For this reason, the monetary policy should be linked up with other policies on foreign trade, investment and structure of industry in order to form a system of measures to achieve a balance between supply of and demand for capital. This strategy could make the macro-economic management more effective.

### (3) *Linking monetary policy to fiscal policy to keep the budget balanced and control the inflation*

To keep the budget balanced is the objective of the fiscal policy while the monetary policy aims at controlling the inflation. Moreover, a balanced budget affects directly the control of inflation, so this third solution is of great importance to the macroeconomic management.

When the fiscal policy tries to mobilize part of the GDP to redistribute according to orientation set by the Government, the monetary policy uses macro-economic regulating instruments (interest rate, required reserve ratio, open market operations, exchange rate, etc.) to achieve a balance between supply of and demand for capital and control the inflation. Thus, we can see that the fiscal policy is realized by the government while the monetary policy is realized by the central bank. In other words, the finance authorities should cooperate with banking authorities in carrying out their policies. In Vietnam, in carrying out the monetary policy, there will be two cases:

+ When the national budget can't be balanced within the fiscal year, the National Assembly will decide how much money to borrow from domestic or

foreign sources. These loans will be of long terms and come from capital markets. The central bank has nothing to do with these loans.

+ When there is a temporary budget deficit because income from taxation can't be collected on time, there will be two solutions:

- The Treasury authorizes the central bank to issue government bonds on the primary market. Commercial banks, after winning the tender, had better sell them to the public, otherwise these banks will become creditors to the Treasury, thereby making this instrument lose its meaning. Moreover when the Treasury borrows from the public by making issue by tender of government bonds, it also helps create conditions for open-market operations in future when money market is developed in Vietnam.

- The central bank can supply short-term loans to the Treasury as allowed by the National Budget Act. The Article 23 of the Banking Law also states: "The central bank can supply short-term loans to the Treasury under the authority of the PM. These loans should be settled during the fiscal year, except for special cases decided by the PM."

In the near future, the exchequer had better stop selling government bonds directly to the public as it has done so far, and make issue of bonds by tender instead. In addition, there should be a regulation forcing the exchequer to repay debts, both principal and interest, to the central bank. This regulation will make the Treasury bear full responsibility for national debts, instead of requiring the central bank to increase the money supply to make up for the budget deficit. These measures will help make the public finance healthier and avoid the inflation.

