The Price of Inflation Control

by Dr. NGUYỄN TRỌNG HOÀI

To stabilize the inflation is a very important issue because it reflects, besides other indicators; such as the growth and unemployment rates, the health of the economy. The crude oil price nears US$50 per barrel associated with some past disasters; such as SARS and bird flu, the inflation really affects both governments and the grass roots. Up to November, the CPI rose to 8.8% and it is expected to reach 9.6% by the year's end. According to Nguyễn Ngọc Tuấn, Deputy Minister of Finance, the inflation rate of the year will vary between 10% and 12%, much higher than what was planned by the National Assembly. The inflation became a topical issue in Vietnam in the last month of the year. The public's fear of increasing prices and the role of the Government in controlling the inflation rate have become an urgent and sensitive problem.

1. What kind of inflation is Vietnam facing?

Of the three kinds of inflation, Vietnam is likely facing the cost-push inflation because most of causes originated from the supply force. The crude oil price rose from US$27 to 50 within the first three quarters of the year and it could be seen as the most important cause. It will take a long time for it to return to old level but it is unlikely. There is no doubt about its effect because the Government had to push the price of gasoline from VND6,000 to 7,000. Facts from many countries show that the price of gasoline always rises and never falls. The bird flu is also a cause from the supply side of the cost-push inflation. When the supply of chicken meat reduced, the public started to use substitutes, which also made the prices of substitutes rise because the demand exceeds the supply. However, the change in the oil price has a greater effect both domestically and internationally.

2. Prediction of the cost-push inflation

According to the Institute of French Petroleum – IFP), the oil price hardly returns to the level of US$30 per barrel. The IFP suggests three scenarios: (1) the price could fall slightly, to somewhere between US$35 and 40, when crises in Venezuela, Iraq, Russia and the UAE are over; (2) the oil shock in the years 1979-82 repeats when these countries fall into political crises and the oil price could rise to US$80 in winter; and (3) the price returns to the US$30 mark when the U.S, EU and China reform their policies on oil import. Of those scenarios, the second one is the most likely because the world political arena is increasingly complicated. If so, the inflation rate will double. This means that not only Vietnam but many developed countries also face the threat of inflation.

3. The price of the cost-push inflation

A high growth rate is a wish all over the world. And it is apparent that all countries will gain only low growth rate when the oil price rises because it makes the supply contract for one thing. For another, measures taken by governments to curb the inflation rate also have their side effects. Tight monetary and fiscal policies could help stabilize the inflation but the price to pay is a higher unemployment rate because the gross investment and spending will reduce while the interest rate and taxes will be higher. During the oil crises in 1972-73 and 1979-80, the unemployment rate in the U.S. was 6% and 7% higher than the previous periods and the respective figures in the E.U. were 3% and 6%. When the crises were over the unemployment kept increasing for three or four years more. Ifzal Ali, the leading economist from the ADB, suggests that the GDP in Asian countries will reduce by 0.8% if the oil price is US$40 per barrel; and by 1.1% if the price is US$50. The International Energy Agency also predicts that the oil price of US$35 per barrel could make the GDP in African countries fall by 3%; Japan's by 0.4%; the U.S. by 0.2% and the E.U. by 0.5%.

Table 1: Forecast of falls in the GDP caused by the oil shock

Country	US$40/barrel	US$50/barre
China	0.8%	1.1%
India	0.8%	1.2%
Thailand	-	3.1%
Philippines	-	2.6%
Asia	0.8%	1.1%

4. Discussions of measures to deal with the cost-push inflation

Although it is assumed that the present oil shock will cause no great damage to the Vietnamese economy because it is offset by the oil income (Vietnam exports some 17 million tons in 2003), the Ministry of Industry predicts that Vietnam will become an importer of fuel by 2013. This forces policy- makers to take precautionary measures when the macroeconomic stability is tied to changes in the fuel price on the world market.

Exchange rate anchor is a measure taken by the SBV. The public felt relief when they heard the exchange rate rose only by 0.8% in the past 11 months although new bank notes were issued. Meanwhile, the dollar kept falling and the gold rising. To stabilize the exchange rate under current conditions could keep the inflation rate under control but the price we have to pay now is the overvalued domestic currency. And as a result, the Vietnamese competitiveness falls when Vietnam has to suffer a trade gap of US$6 billion (it equals 13.5% of the 2003 GDP). In addition,

the fixed exchange rate and interest rate make the holding of the dollar less profitable with the result that the public pour all of their money to real estate when its price is equal to the Japan's and our personal income equals only 2% of theirs. The inflation seems more beyond control when the money supply increases because the Government introduced a new salary scale (thousands of billions of the VND more will be paid from October on).

The tight monetary policy was used by the SBV to curb the inflation. In July 2004, the required reserve was raised from 2% to 5% for deposits in the domestic currency and from 4% to 8% for foreign exchange deposits. However, making such decision when the interest rate had no change leads to increases in bank overheads. More over, the public are demanding a higher deposit rate because they think the inflation is taking place. At present, commercial banks could suffer poor business performance when they couldn't require a higher lending rate and they had to keep bigger reserves. If they are allowed to fix a higher lending rate, companies will face difficulties. Thus, the tight monetary policy could curb the inflation but the price to pay is poorer performance of the financial sector and decreases in the private investment. Such a policy could make the interest rate rise. For example, when the Fed increased the interest rate last August and September, the growth rate in the third quarter was lower than in the second one.

Reducing the import duties or fixing a price ceiling on strategic items, such as fuel, steel, cement and fertilizer, could help curb the inflation. Many governments have adopted such policies and they have had to spend more money to keep these prices stable (in Thailand, gasoline is sold at 21 baht a liter equaling to some VND8,000, but it is sold at VND7,000 in Vietnam). As for lower duties, they reduce the budget income while the public expenditure couldn't be reduced. And as a result, national debt will be heavier. In addition, price support could easily lead to excess of the demand over the supply and development of a black market or speculation in fuel.

There are many instruments for curbing the cost-push inflation but none is perfect. Although Vietnam and many other countries have the same fear of the hyperinflation, we all should realize the fact that any instrument has its own price. The exchange rate anchor leads to poorer competitiveness. The tight monetary policy causes damage to the banking system and reduces the private investment. Lower import duties lead to heavier national debt. Imposing price ceiling goes against the market mechanism and leads to speculation. All prices are dear and all certainly result in lower growth rate and higher unemployment rate.

This doesn't mean that we need not pay attention to the inflation. The Government has determine what kind of inflation Vietnam is facing and what degree it is in before taking suitable measures to deal with it and ensure sustainable development for the economy.■