Economic Development REVIEW

Curbing the Inflation Without Causing Collapse

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To fight the inflation by making the money dearer, reducing the money supply, raising the interest rate, which leads to decreases in the aggregate demand, market prices and export, can reduce the inflation rate and the growth rate as well. A look at the Chilean case study may provide us with a lesson of the fight against the inflation without damaging the economic growth, or causing collapse.

The Chilean inflation rate in 1990 was 20%. The first thing the Chilean central bank did was to announce the inflation target for a year from September of this year to October of the next year. All financial institutions had to follow orders of the central bank in implementing the tight-money policy. The fiscal policy aimed at some surplus for a medium term (from 1991 to 1997). In this period, flows of foreign capital, especially the short-term one, were put under a strict control. The result was a one-digit inflation rate without any damage to the economic growth (8% on average for the years 1991-1997). This growth rate was high in comparison with rates gained by Asian tigers at that time.

Apparently, a good combination of macroeconomic management and employing effectively instruments of the monetary and fiscal policies can fight against the inflation without harming the economic growth. The problem to discuss now is whether the growth rate is reduced to avoid the economic collapse or not. Signs of instability at macroeconomic level make many people give a 'yes' answer. But how to achieve this aim is not an easy task. The following are some approaches to the problem.

1. Fighting the inflation with the fiscal policy

The budget deficit still equals some 5% of the GDP. This figure is acceptable but waste of public expenditure is alarming. The past 5-year period is long enough for us to realize the main causes of inflation include the budget deficit, ineffective use of public expenditure, waste and corruption. Of course, increased money supply and market prices are also significant causes, but the basic one is still the public expenditure.

The mobilization of capital by issuing T-bonds is not effective with the result that the SBV had to buy the best part of bonds issued. In fact, this is an act of increasing the money supply because the budget deficit lasted for several years. In early 2008, the Ministry of Finance issued large sums of VND to buy foreign exchange. This increase took place when the SBV was trying to withdraw money from the market, which showed a lack of coordination between the monetary and fiscal policies. It is only one of cases that show the MOF issued bank notes to cover the public expenditure. Increasing the money supply and turning it into ineffective public investment while the gross product only increases slightly inevitably leads to the inflation.

In the past, especially in 2004, the inflation rate kept rising but the SBV didn't inject more bank notes to buy foreign exchange. In 2007, the SBV issued money to buy some US$9 billion, which became some more oil poured on the flame of inflation that had started long before. That is why cutting the public investment becomes one of long-term measures taken by the State to fight the inflation.

Case studies show that Bolivia is an example of how policies were used for fighting against the inflation in the 1980s. In the first half of 1985, the inflation rate in Bolivia rose to 11,000%. Its government cut the long-lasting budget deficit to the bone, restructured the public sector, imposed taxes on assets with high added value. Strong measures and government's determination to fight the budget deficit and waste of public investment helped restore confidence among companies and the public as well. The market responded positively to this determination by offering an expectation of a lower inflation rate in future prices of commodities and interest rate. The inflation reduced quickly when the market shows confidence in the government's effort. All economists were surprised at its success in fighting the inflation with a possibly lowest price.

2. Money shouldn't be injected into circulation to save the stock market

Firstly, we need not raise the question of what interested groups are saved by increases in the money supply. Recently, the Government has suggested stopping discharge of mortgaged securities. This measure is only acceptable if it is agreed on by banks, stock firms and investors. In the near future, if the SBV increases the money supply to provide banks with more cash, its decision is not acceptable because this act makes the public think that the stock market is in a crisis or the SBV is trying to save some interested groups. The stock market only reflects moves of investors, so rises and falls in this market are normal. Administrative interventions not only harm the economic growth but also make the inflation more serious, not to mention inequality generated by the wrong use of taxpayers' money.

3. Employing interest and exchange rates instead of controlling strictly liquidity

Many experts have recently been of opinion that it's better to appreciate the VND to fight the inflation. It is acceptable when the dollar is falling and flows of foreign capital to Vietnam are on the increase. In fact, the current inflation rate is alarming but it is not high enough to make reducing the supply of credit strictly and suddenly necessary. The SBV can employ such instruments as interest and exchange rates instead of reducing the supply of credit, but appreciating the VND as a measure to fight the inflation seems dangerous because it may be a policy that deviates from our usual line.

Theoretically, the appreciation of the domestic currency helps reduce the inflation because it lowers prices of imports, and then, prices of outputs, and the general market prices. Expanding the band on both sides of the exchange rate, of the use of the exchange rate as an instrument for curbing the inflation must be considered carefully under current conditions.

There is, perhaps, some confusion about "flexibility" of the exchange rate. The flexibility means that the exchange rate of the dollar to the VND can fall but it is impossible to let it fall constantly as seen in recent months. When the SBV stopped buying foreign exchange, commercial banks followed it because they knew the rate would keep falling. Even if the band increases to 5% or 10%, it can't solve the existing contradiction: the banks don't want to buy the dollar while the demand for it tends to rise. To keep the exchange rate flexible, the money supply can be increased to a certain extent, and for the time being, top priority could be given to purchase of foreign exchange from exporters. This measure can limit the appreciation of the domestic currency.

Adopting a flexible rate means that the SBV need not worry about the volume of foreign exchange it should buy and it can concentrate in the use of the interest rate as an instrument for fighting the inflation. IMF experts have also suggested this measure. The tight-money policy proves that many mistakes have been made in the past, which caused companies and banks face shortage of cash.

Will a flexible exchange rate curb the inflation? To answer this question, we should calculate effects of the exchange rate on prices of local goods and inflation rate. If these effects are weak, the exchange rate can hardly curb the inflation.

A BIS working paper prepared by Jonathan McCarthy in 1999 argues that the pass-through of exchange rate to prices of goods and domestic inflation is complicated and relies on four factors: (1) import share; (2) exchange rate volatility; (3) GDP volatility and (4) competitiveness. This study shows that relation between exchange rate and domestic prices is weak, that is, we can hardly conclude how much the Vietnamese GDP will fall when the VND rises by 5%. A study by Corsetti and Dedola (2002) shows that the pass-through is very weak in countries where competition is not perfect.

The conference held by the Bank of Canada in January 2002 argues that the condition for a perfect pass-through is the really flexible domestic price. Papers presented at the conference prove that the exchange rate and import price shocks produce little effects on the domestic inflation. These studies are good for those who maintain that the exchange rate is not an effective instrument for fighting the inflation.

Realities in Vietnam show us how much differences between prices of telecom service, fuel, drugs and milk on domestic and international markets are. Moreover, the Government can't implement its policies by taking very simple actions, such as paying in EUR when the dollar falls, or deciding to buy American goods when they become cheaper. The dollar starts to rise now. If this trend prolongs, can we import cheaper goods from Europe or Japan, and want to pay them in the dollar? Export contracts can't be changed overnight. In developed countries where domestic prices respond quickly to the exchange rate, it takes at least 12 months for appreciation, or depreciation, of the domestic currency to produce effects. This means that the appreciation of the VND will take a longer time to produce effects because of poor distribution network and existence of many monopolies.

In a recent report, the WB suggests a way of using monetary and fiscal policies to deal with "three infeasible policies" that comprise: liberation of movements of capital, fixed exchange rate and independent monetary policy. To deal with this trio, the WB suggests adopting a flexible exchange rate with a slightly wider band but avoiding shocks caused by a tight-money policy. The report says the current band of 2% in Vietnam nowadays is acceptable. WB remarks include no suggestion about the use of exchange rate as a strong instrument for fighting the inflation.

4. Don't brake suddenly and cause shocks

Under current conditions, decisions to tighten the supply of credit and raise the price of fuel were like oil poured on the flame that harmed the economic growth. Many experts are of the opinion that Vietnam should prevent the flow of foreign capital, as Thailand did in late 2006. It's worth noting that the price for this decision was the massive withdrawal of capital by foreign investors in one day only. Of course, it's necessary to prevent foreign capital used for speculations but it's difficult to distinguish between short- and long-term foreign indirect investments when investors can easily transform long-term investment to short-term one by employing derivatives. Thus the best approach is to check quality of flow of capital instead of its maturity, by setting regulations on managerial ability or size of foreign mutual funds for example.

To deal with the current situation, the Government should adopt flexible and gradual measures to avoid collapse. Interest rate is increased by degrees and lowered gradually when the inflation seems to slow down. The band of the exchange rate could be expanded slightly in order to keep it from exceeding the equilibrium point. Other policies must be implemented to remove pressure on the economy, such as deflating bubbles in the realty market, restricting credits for investors in the realty market, and tightening the public investment. This doesn't mean that all major public investment projects should be revoked because this act will affect badly the employment rate and long-term development. What must be revoked are ineffective projects that cause huge waste and corruption.

5. Conclusion

The latest sequence of events show that strong anti-inflation measures started to produce counteractions. Implementing the tight-money policy to fight the inflation is right but it is not acceptable for the SBV to refuse to buy foreign exchange, especially from exporters, as it did in recent months. This decision causes harm for economic growth without ascertaining whether it could curb the inflation or not. When the fight against the inflation is carried out by scientific measures instead of administrative decisions, the economic growth can be saved from unnecessarily bad effects. The Government's determination is fierce, but it's good cooperation among ministries and agencies that ensures the success ■

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