

Inflation and Anti-inflation Struggle Seen from Aspects of Monetary Policy



an interview with Prof., Dr. Cao Cự Bội

Editor's note: Prof., Dr. Cao Cự Bội (CCB) has taught and researched financial and banking issues, and worked as an expert for the Government for years after the economic reform was launched, and as a financial expert for Kaysone Phomvihane, Laotian President and PM (1988-1990). On his visit to HCMC, the EDR conducts an interview with him on the monetary policy, inflation and anti-inflation struggle, the most topical issues now.

EDR: To implement the monetary policy and carry out measures to curb the inflation is a matter of concern to the Government, financial authorities, businesspersons and the public as well. Please tell us about changes in the inflation rates in the past few months.

CCB: Inflation rate in Vietnam, in my opinion, has started in the past few years and reached a two-digit level in the last quarter of 2007, and in the first two months of 2008 it was 6.02% (EDR's note: the inflation rate in the first quarter of 2008 was 9.19%). I think this sequence of events is a result of economic activities in recent years and the economy is suffering two types of inflation: cost-push inflation and demand-pull inflation. The two types run parallel but in this period, due to latency of increases in the money supply, the demand-pull inflation took place. If no urgent measure is taken, the inflation may become hyper-inflation. In addition, increases in the cost of important goods and services also leads to the inflation in Vietnam because of its high ICOR that varies between 4.0 and 4.4, that is, a unit of growth requires 4.4 units of capital. This means that over 30% of the GDP (and some 40% in 2007)

is turned into investment while Taiwan and South Korea have used only 20% of their GDP for investment for decades, succeeded in developing the economy and keeping the ICOR at 2.5% or 3.0%. Thus, the inflation has made its appearance for several years.

In recent years, the Government has managed the economy with optimism and felt too content with a high growth rate. With such a high ICOR, the economic growth has a poor quality. Talking about the cost-push, we usually blame higher prices on the world market. In fact, one of main factors of the cost-push is the public investment in unproductive projects while the whole economy suffers another factor caused by poor competitiveness. In the *Global Competitiveness Report 2007-2008* published by the World Economic Forum, Vietnam ranks 68 among 131 surveyed countries. Vietnam's human resource is of poor quality, and added value and technological content in its exports are low while it suffers high cost-push because of its import of expensive raw materials and technologies. The trade gap is inevitable. The more we want to increase the growth rate, the higher the trade gap is. Other factors of the cost-push are poor implementation of macroeconomic policies, poor planning, widespread corruption and waste of public funds.

EDR: What is the main reason for the two-digit inflation rate in 2007 and high inflation in the first quarter of 2008? Is the implementation of macroeconomic policies considered as one of reasons for the inflation?

CCB: Taking a long view, we see that the inflation relates to the cost-push, and to the implementation of monetary and financial policies in a short term. We have

contended ourselves with the economic growth. There are real and virtual kinds of growth because we have to spend money. Increases in the M2 in the past three years got higher and higher and this increase in 2007 reached some 35%. The increase in the money supply, along with the poor implementation of the monetary policy, produces inflationary effects. The domestic currency has a greater latency and elasticity in comparison with gold, therefore the gold price skyrockets when the money supply rises suddenly. If we can stop it cleverly and vigorously, the hyperinflation may occur. In the past, the Government has paid attention to the economic growth more than inflation prevention, which shows itself in the implementation of macroeconomic policies. Liberation of the finance market is an inevitable step when developing the market economy and integrating into the world market. If we take this step carelessly, a bubble may come into being. In fact, the flow of foreign indirect investment to Vietnam in recent years hasn't been too large and it hasn't produced remarkably bad effects. But the SBV couldn't cope with fluctuations in the market and fulfill its tasks as required.

EDR: *Is inflation prevention or economic growth the first target for Vietnam today?*

CCB: Everybody knows the principle but they all forget it. We act romantically when doing our business and we are so content with the economic growth that we fail to think of the quality of growth. In addition, there is always some contradiction, in principle, between the inflation and growth rate. Everybody knows that financial intermediaries play an important role because they help turn savings into investments. Sometimes, we try to regulate the mechanism and, for unknown reason, end up in speculation, and we have speculate on the realty and stock markets, the center of bubbles.

Vietnam should gain economic growth. It is definite because we will have no development without the economic growth, not to mention the economic integration. To gain some sustainable growth, we should constantly think of inflation prevention and regulate the economy with this aim permanently in mind. Those two ideas should run parallel. We have long considered the economic growth as principal and inflation control subsidiary. Of course, the Government always says the inflation rate should be lower than the growth rate, but in fact, we need right measures to achieve this aim. With such increases in the CPI, the inflation rate is never lower than the growth rate. Although the sustainable growth is our slogan and strategy, we should constantly think of inflation prevention. There are two

principal measures to deal with the inflation. The constant one is to work out appropriate monetary policy; and the strategic one involves the financial policy, performance of the managerial machinery and contribution from the public.

The inflation is a constant danger but the monetary policy aims at short-term objectives. The short-term policy should be adjusted frequently, which requires competence of the SBV, and sophisticated operations of the central bank manifest themselves in the monetary policy. This policy may cause some shock. Today, the central bank can raise the interest rate but it can be lowered tomorrow morning or next week. Similarly, the exchange rate may rise now and fall in two weeks. This reflects competence of regulators and requires service of a superb think tank.

EDR: *Is it necessary to keep the inflation rate lower than the growth rate, or allow it to go higher than the growth rate at times?*

CCB: This problem must be handled flexibly. NA members usually want to have the inflation rate that is lower than the growth rate. This is unrealistic because the inflation is very complicated. It reflects itself in a subtle system of transmission in the monetary policy and it must accelerate the growth rate in a sustainable manner.

EDR: *What are your opinions about the implementation of the monetary policy by a series of measures introduced by the SBV recently with a view to stopping the inflation?*

CCB: The inflation rate reaches a two-digit level now and it may become hyperinflation if the monetary policy is implemented carelessly. Authorities must act immediately to stop increases in the inflation rate. Why? Firstly, the money supply increased considerably in the past few years, and the latency breaks out now. Secondly, the flow of foreign capital in 2007 alone amounted to some US\$25 billion while the immigrant remittance was estimated at US\$45 or 6 billion but in fact it might be 10 billion. The ODA amounted to several billions, the FDI 6.5 billion and foreign indirect investment in the stock market passed the 5-billion mark. The foreign capital sent to Vietnam was employed ineffectively and partly used for covering the trade gap (US\$12.5 billion in 2007) while the interest rate on deposit in the dollar offered by local commercial banks was very low, from 4.5% to 5.0% a year.

At present, the Government should take strong measures to curb the inflation but it should see to it that the administrative and economic machinery still runs well. In my opinion, the SBV, when carrying out the measures,

should keep in mind that no solution is perfect and it always involves both good and bad aspects. During the worst period, it's very good to achieve some 60% of the planned target. In addition, the SBV need not be afraid of public opinion. The decision to limit credit supplied to investors in the realty market has produced good results in spite of protest from real estate companies and developers. I agree with an opinion given by a newspaper, "Should we give up interests of the people to protect real estate tycoons?"

As for the banking system, the SBV should give top priority to the inflation prevention. To curb the inflation, the required reserve could be used as an instrument for reducing the M2. To force banks to buy T-bills is also a useful measure to achieve this aim. In addition, the central bank can employ open market operations and refunding to ensure solvency for banks, and set the ceiling rate of interest at 9% or 10% a year for the open market operations. (EDR's note: The SBV, in February, 2008, raised the base rate from 8.25% to 8.75%; discount rate from 4.5% to 6%; and rediscount rate from 6.5% to 7.5%). In my opinion, the SBV measure is right, in terms of formal logic.

EDR: May these successive measures cause psychological shocks?

CCB: I want to mention here a lesson from our history. In August and September 1988, Vietnam faced a 3-digit hyperinflation. Applying the reward-to-depositors theory, the SBV, as from Sep. 23, 1988, offered an interest rate of 12% per month, and 9% per month for current accounts. I think it is a shotgun solution and a poison, and shocks must be treated immediately. I mean that the central bank has to take hold measures when necessary.

The SBV has just introduced a series of measures: increasing the reserve requirement, forcing commercial banks to buy T-bills, and employing actively the discount rate, etc. These measures caused various reactions but this situation is normal because the monetary policy is implemented by intermediary institutions and a transmission mechanism.

EDR: How does the inflation affect local commercial banks? What are your opinions about the interest-rate war among commercial banks although it has been stopped?

CCB: Signs from the finance market, to me, reflect the supply-demand relation, therefore the SBV must study these signs and delete signs from speculators. This market is sensitive and changeable. It changes every day and hour and is also affected by overnight rate. There has been an interest-rate war on the market. There are many reasons for this war and among them is the fact that many banks

turned short-term capital into long-term loans because of some profit with the result that they could not control the growth of credit. In my opinion, the implementation of the monetary policy at present should aim at curbing the inflation and controlling strictly the growth of credit. I means 'controlling,' not 'restricting' the supply of credit, because restricting the supply of credit to small and medium enterprises means making the whole economy collapse. To control the credit supply, the short-term interest rate must be lower than the longer one and a mechanism for controlling the liberation of the finance market must be established. When the SBV want to withdraw money, it should offer an interest rate that is higher than the inflation rate but it must not let this offer last too long in order to avoid crises. Next, public expenditure and investment must be well under control, and prevent ineffective projects from causing waste and corruption. If this effort is not carried out successfully, the SBV has its hands tied.

At present, Vietnam still has potentials for development in spite of numerous difficulties: foreign capital keeps increasing; socioeconomic conditions are favorable; reforms launched by the Government are healthy and appropriate to WTO policies. However, if the inflation becomes hyperinflation, bubbles will make their appearance in the realty and stock markets and force foreign investors to withdraw their investments. It's worth repeating that the implementation of the monetary policy is the most important task of the central banks. Full attention must be paid to this policy when working out the plan for economic growth. To achieve this aim, the Central Bank Law and other laws relating to financial sector must be adjusted as soon as possible.

EDR: How about the exchange rate?

CCB: As we know, low exchange rate can promote export and a higher one encourages import. We should know who we are. Vietnam can't follow Chinese policies because China enjoys a very big trade surplus. Vietnam has just joined the WTO for one year and its trade gap amounted to US\$12.5 billion in 2007. Most exports from Vietnam have a low added value and are produced by labor-intensive industries. With a lower exchange rate and a big trade surplus, if the problem of foreign trade is not handled cleverly, the trade gap may rise from 12.5 to 20 billion (EDR's note: the trade gap in the first quarter of 2008 was US\$7 billion). It's necessary to consider various factors, including inputs and outputs, carefully. Adjustment of the exchange rate should not be done abruptly and only

trading band can be used for adjusting the rate (*EDR's note: On March 7, the SBV increase the band from 0.75% to 1.0% either side of the average rate offered by the inter-bank market*). I support this decision. We should solve the problem of the exchange rate by considering real conditions in Vietnam instead of relying on theories or advice from foreign experts. Liberation of trade in foreign exchange is a deadly and ever-changing spiral when the flow of foreign capital to Vietnam is on the increase. Stable exchange control is necessary but we had better avoid making it fixed for a long period.

EDR: Finance and monetary markets play important role in the struggle against inflation and deflation. One of measure to withdraw money from circulation is to issue bonds in domestic and foreign currencies. Is this measure feasible under current conditions?

CCB: Vietnam has issued bond on foreign markets some years before because of attractive rate of interest and failed to pay proper attention to the domestic market. The monetary and capital markets should be linked together. Bonds in the VND issued by both the Government and companies are not attractive. When issuing bonds to reduce the inflation, the interest rate offered must be particularly competitive.

EDR: Could you tell us about an overall measure to control the inflation through monetary policy for the time being and in the long run?

CCB: I think, for the time being, authorities should:

(1) Exert strict control over both foreign and local participants in the monetary and capital markets and prevent unhealthy flows of foreign capital.

(2) Employ flexibly instruments of the monetary policy in order to fight demand-pull inflation, and ensure the balanced supply - demand relation and smooth movement of disposable capital among financial institutions.

(3) Policy on the exchange rate should be linked with the trade policy with a view to diversifying goods and services, reducing the trade gap and supporting the economic growth.

(4) Beef up policies on production and commerce, and on support for local companies in order to help them cut production cost, increase added value and technological content in their products or services, and enhance their competitiveness.

(5) The final task is still the implementation of monetary and financial policies. Full attention must be paid to national interests instead of individual ones of some province, ministry or industry.

I think Vietnam hasn't fallen into crisis and it can recover soon if the monetary policy is implemented effectively and constantly. Authorities must know that the inflation is a price for economic growth.

EDR: How can the SBV reform itself to enhance its competence and performance?

CCB: Good leadership means success in persuading talented personnel. Human resource is always available but they need a proper mechanism. This mechanism includes various factors: financial incentives; respect for capacity of the staff; and reasonable salary to retain competent employees. The central bank should be a special organization but it is a bank before it acts as a governmental agency. As a bank, it must know how to employ financial regulatory instruments. The core problem is still how to perfect the existing mechanism and make laws and regulations transparent. At present, tasks done by the SBV are satisfactory because we have no other choice.

EDR: What lessons we can draw from the implementation of the monetary policy in the past?

CCB: The first lesson is that the predictions must be made regularly. To make predictions regularly, we need a good machinery, more investment in the human resource, technological facilities and financial sources instead of formal speeches. Without predictions, authorities have been too content with some success or achievements and failed to realize a pending inflation.

The second lesson is how to control and supervise the situation practically instead of doing it as a formality. To achieve this aim, the mechanism should determine responsibility of supervisors by setting forth clear rewards and punishments.

The third lesson: the implementation of the monetary policy to prevent the inflation must be carried out consistently and uniformly and free from contradictions caused by acts by different governmental agencies.

The fourth lesson is to avoid excessive optimism and getting content with the economic growth. All measures generate reactions but positive opinions from the majority must be respected. It is not wise to get angry or hurry when facing negative reactions just because of individual interests.

The fifth less is importance of transparent policies, laws, mechanism, organization and information supplied to the public.

EDR: Thank you for an interesting conversation. We wish you good health and success in contributing to the development of the financial- banking sector ■