DEVALUATION AND IMPROVEMENTS IN TRADE BALANCE

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Until recently many articles when referring to measures to stimulate the spending power argued that the value of the domestic currency was rather high in comparison with currencies in neighboring countries. This high value affected badly the competitiveness of local companies and increases in the aggregate demand because it favors import instead of export.

Could devaluation, as an act of reducing the value of the currency by a government, affect favorably the economy?

The answer depends on the situation before the devaluation takes place, size and duration of measures to reduce the market demand and encourage the production. This also depends on relative size of sectors producing all kinds of goods, on their reaction to changes in the exchange rate, on elasticity of demand for imports and import substitutes, on the government's management ability and some other factors. Thus, this is not a problem that could be decided on without careful consideration.

1. Devaluation, trade balance and economic growth

Theoretically, devaluation will make exports cheaper for foreign buyers and imports dearer for home buyers, and thus encouraging domestic sectors to produce exports or import substitutes and reducing consumption of imports. According to Keynes, the devaluation will stimulate demand for local goods and make the national income increase by geometric progression.

The size of reaction, however, depends on kinds of imports and exports. In other words, it depends on the price elasticity of demand for imports and supply of exports. In Vietnam, as in other developing countries, the price elasticity is usually low because the demand for imports originates from increases in demand for intermediate goods and capital goods that couldn't be made locally, and poor supply of import substitutes while exports are mainly farm products that take a long time to produce and couldn't be sold out domestically. In addition, the low elasticity also comes from poor velocity of capital goods between sectors, poor information, poor infrastructure and other troubles. In other words, Vietnam and other poor countries aren't sensitive to stimuli caused by devaluation. Thus, actions on defects in the management mechanism that limits the elasticity could be more effective than the devaluation.

2. Managerial ability

The devaluation should be combined with other supporting measures. Carrying out all these measures at the same time, however, is no easy task. Fiscal, monetary and other regulating policies should be suitable to the policy on exchange rate. These policies, to a certain extent, are alternative. Strict financial and monetary discipline could ensure a stable exchange rate and a floating rate is suitable to a looser fiscal and monetary policy. The need for the coordination of macroeconomic policies is mentioned in discussions on potential inflationary effects by devaluation; the government should control the aggregate demand in order to avoid inflation that could neutralize effects of the devaluation; and at the same time; avoid the situation in which the demand is satisfied too much and investment strangled. Moreover, the devaluation usually doesn't produce all of its good effects, unless it is combined with supporting measures dealing with macroeconomic aspects and supply forces in order to beef up the economic infrastructure and develop marketing services.

3. Effects of devaluation on the national budget

Effects of devaluation on the budget income and expenditure complicate the problem. Contrary tendencies exert their influences again.

First of all, the devaluation could increase the budget income, especially when more taxes are imposed on foreign trade because the values in domestic currency of imports and exports will rise. If the price elasticity of demand for imports isn't high enough, the devaluation will produce good effects on income from import duties, unless they are regulatory taxes and the government uses reduction in tax rates as a compensation for devaluation.

When imports, including raw materials, are subject to excise duties, this source of budget income may rise. If the devaluation makes increases in output of tangible goods higher than decreases in volume of intangible goods, the budget income from corporate tax and personal income tax will rise. Income in domestic currency from non-refundable aid to the government also rises. Thus, the devaluation could generally make the budget income increase.

As for the budget expenditure, it depends on: the volume of government's foreign debt; government's purchase of imports; and pay rise in the public sector made by the government because of devaluation. In Vietnam, the foreign debt is rather big. This means that a bigger sum of domestic currency is needed for debt repayment. The excess of budget expenditure over the income leads to a budget deficit. Moreover, private companies with big foreign debts also face financial difficulties with the result that the government is forced to take over these debts in order to avoid bankruptcies and a higher unemployment rate. This situation will certainly lead to bigger budget deficits and inflation rates.

Thus; effects of the devaluation on the national budget are serious and unpredictable, therefore the introduction of supporting measures becomes more difficult.

4. Dangers of recession and inflation

The devaluation may spark off an increase in inflation rate because in Vietnam necessary raw materials, equipment and many factor inputs, and certain consumer goods are imports. Devaluation makes imports dearer and increases production cost: producers have to spend more on imported raw materials and labor cost. Therefore, real effects of depreciation will be neutralized and the real exchange rate will soon be lower. Another danger is the fact that the devaluation may lead to recession along with inflation. Rises in prices will at first reduce the spending power and increase the production cost. The same investment will be only enough for a smaller volume of output. There is an alternation of effect causing inflation and that causing recession but subsequently the inflation becomes more certain and economic activities duller. However, the effect causing increase in demand may be greater if it causes real income to transfer from suppliers of intangible goods with a low marginal propensity to save to suppliers of tangible goods with a higher propensity to save.

When the currency is devalued greatly, producers who depend on imported raw materials usually meet shortage of working capital because they need a bigger capital to maintain their business before they could transfer additional cost to consumers. This effect will be amplified if the producers owe big debts to foreign creditors. Such shortage of working capital is very common and it may increase the inflationary pressure, especially when the credit control prevents banks from satisfying the producers' increasing demand for loan.

The potential inflationary effect could be used as an argument against the devaluation in two ways: Firstly, recession may lead to decreases in investment because both demand and trust are reduced hindering necessary structural changes needed for reallocating resources to industries producing tangible goods. Secondly, the price paid for the use of this instrument is usually too high if it leads to great decreases in production, employment and personal income. Thus, it's necessary to find out alternatives that require lower prices to pay and allow bigger output.■