A Comprehensive App

Some suggestions for a comprehensive solution to fighting inflation

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Huge amount of money disbursed for ineffective infrastructure construction projects is one of the reasons for high inflation

A monetary tightening policy is necessary to fight high inflation. However, if measures to implement this policy are too strong, they will worsen the liquidity crunch of commercial banks. This situation shows the great difficulty in being able to achieve the twin goal of curbing inflation and maintaining the financial intermediary role of commercial banks in channeling savings money into investment projects.

The fast reduction of money supply will weaken liquidity and increase borrowing to repay loans in the banking system. Therefore, measures to lessen the pressure of the monetary tightening policy, if any, are unlikely to help restore liquidity but are certain to make inflation regain its upward trend. There are suggestions that the Government should make a drastic cut on spending for costly but ineffective projects. However, this measure also implies a possible drop in economic growth and rising unemployment. So where is the way out?

A deep look into inflation

It's the common knowledge that the fundamental reason for high inflation today is budget overspending, as huge amounts of money have been disbursed for ineffective projects in infrastructure construction, export promotion or production of import substitutes. However, this is a structural problem that cannot be solved overnight. In this context, is there any solution that can help curb inflation at an acceptable rate without heavily damaging the liquidity of the banking system?

Under the pressure of offsetting budget deficit, a central bank must resort to taxation through the banking system by either raising the compulsory reserve or increasing money supply. In this context, the interest rate for deposits must be raised as a way to compensate for the expected inflation. However, a consequence of this measure is the gap between the deposit and lending rates must be widened to help banks hedge against inflation and secure the liquidity that is weakened due to the requirement for higher compulsory reserves or for buying huge amounts of treasury bills. In other words, commercial banks must raise the lending rate to a level much higher than the rate for deposits.

However, in the context of a frozen financial market, only a few of the riskiest projects can afford the excessively high lending rate. Therefore, commercial banks are forced to borrow to repay loans in the hope that if they are able to overcome the tough time they could regain their strength, and if there is a credit crisis that makes the banking system collapse, the State, not themselves, will be the final entity that bears the responsibility.

With this hope, banks with less prestige are engaged aggressively in the rate war. However, if high inflation continues, big banks will also have to join the race. It is in this dire situation that emerges a solution. If all the parties expect inflation will go down over the long term, the pressure on compulsory reserve will lessen, and the financial market will regain its buoyancy. Any bank that continues to join the rate war will face bankruptcy. This is the reason why big banks refrained from joining the rate war several weeks after the

Tet holidays. At that time, instead of pumping VND39 trillion into the banking system through the open market operations, the State Bank of Vietnam might choose to cut the compulsory reserve and reschedule or reduce the compulsory purchase of promisory notes. With this move, inflation would be kept at a lower rate.

A comprehensive approach

A comprehensive solution for fighting inflation must take into account the removal of a structural problem, that is heavy budget spending for big "development" projects which lack due consideration. This solution also requires a look into imbalances in foreign trade and payment.

Since the open door policy was implemented, a huge amount of foreign capital and short-term loans has flowed into Vietnam. This strong money inflow, on the one hand, has stimulated the development of ambitious "development" projects, but, on the other hand, has pushed up inflation due to the increased foreign reserve at the central bank. However, if the investment efficiency is low, it will cause "bottlenecks" in the economy, such as shortage of energy, and increase inflation further.

When the inflation rate exceeds two digits, it will push up the real exchange rate, which in turn will affect exports. This may also coincide with the time that short-term loans fall due, and businesses and exporters must take out new short-term loans to repay the loans that fall due. The owners of big projects will also take out loans to import more, as the higher real exchange rate will benefit this activity.

As a result, trade deficit rises fast together with inflation and debt. An imbalance spiral on the macro-level is developed. High inflation affects exports and causes trade deficit. Then the payment deficit of the borrower, plus the lender's aggressive seeking profit in an emerging economy, further stimulate the inflow of short-term funds into the economy, thus increasing the inflationary pressure. The scenario of the economy falling into hyperinflation and then debt crisis is laid out clearly.

To prevent the happening of this scenario, the Government should apply a flexible exchange rate mechanism to improve investment efficiency and boost exports, instead of increasing budget spending and foreign borrowing to finance "development" projects. When foreign fund inflow surpasses the economy's capacity to absorb it, which is manifested through rising trade deficit and inflation, a slight increase in the real exchange rate is necessary, as it would allow a lower inflation rate compared with the appreciation of the local currency. As a result, the real exchange rate will increase, benefiting exports and improving the payment capacity, and thus reducing the pressure to take out short-term loans.

Furthermore, the increase in the real exchange rate will also encourage the inflow of longer term loans into sectors that have strong export potential. Such a trend would allow a gradual reduction in budget spending for export promotion, as well as the fabrication of ineffective "development" projects.