USING THE INTEREST RATE TOOL TO CONTROL INFLATION IN VIETNAM

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Inflation is considered as a phenomenon associating with the market economy, so in modern economic circumstances, controlling inflation is one of the essential targets of each nation. However, how to control inflation is not easy as inflation results from different causes and occurs in different economic and social circumstances in different nations, which makes use of the different interest rate tools in controlling inflation to gain various goals. This article discusses the use of the interest rate tool in controlling inflation in Vietnam - based on the successful lessons and the limitations of this tool.

1. The Basis of Controlling Inflation by Interest Rate

With regard to the relationship between interest rate and inflation, there have been many research works and a shared admission is that they are closely related. The economist, Fisher described an equation:

\[ i = i_r + \Pi^* \]  

\[ \rightarrow i_r = i - \Pi^* \]  

\[ i: \text{interest} \]
\[ i_r: \text{real interest} \]
\[ \Pi^*: \text{estimated inflation rate} \]

Formula (2) shows that when the estimated inflation rate increases, it will make the real interest rate decrease reflecting the decrease in the real costs of interests of the people participating the credit market, which is beneficial for borrowing money, but damages lending. Therefore, the demands for borrowing money increases, but the supply of borrowing money decreases, the interest rate grows. The increase in the estimated inflation rate will result in the increase in interest rate, which is the effect cited by the economist, Fisher and is called Fisher effect. This effect implies that if you fight against inflation by lowering interest rate, it is certain that you will fail: the inflation will increase.

Economists studied and illustrated the relationship between inflation rate and interest rate in the nine developed countries including Italy, France, Canada, Holland, Japan, Germany, Switzerland, Brussels in the period of 1982 and 1983 (This is an international research on the relationship between interest rate and inflation. The research shows that countries which experience the high inflation rate are the ones which have high interest rates. Three nations which have the highest inflation rates are Italy,
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France and Canada and they are also the nations which have the highest interest rates; four nations which have low interest rate are Japan, Germany, France and Switzerland, and they are also the nations which have low interest rates.

In brief, they admitted in theory and in practice that the relationship between interest rate and inflation is undeniable. It is the basis for using the interest rate tool in controlling inflation in many different nations in modern economic circumstances.

The Federal Reserve System of the United States of America (FED), together with other tools, actively used the interest rate tool in controlling inflation during the decade when the economy faced the invariable situation of inflation rate. In the years of 1979 and 1982, the inflation rate in America was always at the two digit level. By raising the discount rate to a high level in America's history (10.5% in 1980 and 11.5% in 1981), and therefore, the interest rate amounted to 13.36% in 1980 and 16.38% in 1981, did FED reduce the inflation rate from 13.7% in 1979 to 8% in 1980 and 6.1% in 1981, 1982. In France, at the end of 1978, the economy faced the situation of two digit inflation until 1981, 1982. In 1981, the Central Bank of France had to raise the discount rate to 17.5% and the market interest rate to 28% - the highest interest rate in France's history, in order to repel the inflation. Within only six months, the discount rate was raised twice as much as in 1980. The solution to the problem of raising interest rate in reality is considered as the solution of many nations, including developing nations. Since 1983, controlling the interest rate has been popular in Latin American countries and it has also become the primary factor in the stabilization programmes of Korea and Taiwan in the middle of the 1960s, and Indonesia in 1986 and 1974. Some other nations such as Japan, China fell into inflation in the 1990s of the twentieth century. The inflation rate of these countries was at the minus level (Japan: -2% / year, China: -2.6% / year). The governments of these countries had to use many different measures and tools to overcome deflation, including lowering interest rate (Japan implemented the zero interest rate, China from 1996 to July, 1997 seven times lowered the interest rate).

However, using the interest rate tool in controlling inflation cannot stay for a long time. If the increase in the interest rate lasts to fight against the inflation, it will decrease investment, total demand and output and unemployment will rise. The fact in the countries fighting against inflation by using these tools has proved this. When America controlled the inflation at the one digit level in 1980, 1981, the price they had to pay was the regression of total demand and output, so from the end of 1982, Fed lowered the interest rate from 11.5% in 1981 to 9.25% in 1982. The same situation happened in France, fighting against the two digit inflation by raising interest rate, the total...
demand decreased at – 5% in November, 1981. This implies that using the interest rate tool in controlling inflation can affect the implementation of other economic targets and that using the interest rate tool should be carefully considered.

Moreover, it is impossible to use the interest rate tool to overcome inflation in any cases because inflation results from different causes. The interest rate tool is best used when the growth of money is too high; at that time raising the interest rate will restrain inflation.

2. Controlling Inflation by the Interest Rate Tool in Vietnam

By 1981, inflation in Vietnam had not been admitted, but the retail prices of commodities and services in the market increased by 20 % per year. From 1981, inflation was at the level of 69.6 % per year, but it was not admitted in the official documents. The government dealt with it in the aspects of “price, salary, money”, mainly by administrative measures. In 1986, inflation reached the level of 747 % per year and after that it remained at the three digit level for three years, which placed Vietnam’s economy in the “galloping inflation” of high level. The two digit inflation went on until 1995 (in 1995: 5.3 % / year). Thus, entering the economic renovation, Vietnam confronted the inflation which was very high and lasted many years. Such a serious inflation level forced the State to issue the money continually in order to meet the spending requirements of the economy, and this again made inflation continue to grow. The salary in circulation in 1976 was considered as the survey market; it increased by 2.2 times in 1980; 29.9 in 1985; 131.1 times in 1986; 548 in 1987. The amount of money issued circulation was so high that it made prices of commodities increase constantly. In such high inflation, it was the first time the State of Vietnam raised the question of fighting against inflation. Then anti-inflation programmes were drawn up in many offices under different levels of branches. Thus, at that time there was a renovation in the view and acknowledging inflation. From then on, measures of fighting against inflation were defined, associating with the steps of implementing the economic renovation such as carrying out the market mechanism, widening the self-operational rights of enterprises, reforming economic policies etc. Especially, the reform of financial and monetary policies also used the tools of monetary policy, including the interest rate tool in controlling the inflation.

By 1989, interest rate had only been considered as a tool to implement the reallocation of national income, decrease product prices, and return of high expenses. Because of such a point of view, interest rate was not considered as a tool of price and thus it was not used as an economic tool. The interest rate been used during this time period mainly as a political aim and content, describing discriminatory treatment between economic
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cors and units and showing the state's
imation to the state enterprises.
ically, it is the real interest rate that
minus, thus the interest rate
cribed by the state was always lower
zero for a long time. With such
rate policies, interest rate
ened inflation.

First, interest rate did not encourage
aving in the economy. In 1993, if a
et kept 1000 VND in the bank, the
le of that sum of money would be
ivalent to about 700 VND; similarly, in
it would be equivalent to only
D. With low income, the households
am only had a very little amount
avings, they couldn't allow that sum of
ey to devalue when keeping it in the
, so they often used that amount of
ey to buy commodities, gold and hard
cies. As a result, the prices of
modities of different kinds were
ving and inflation was worsened.

Second, the minus interest rate
fited the capital borrowing
prises. In the condition that
modities were scarce and commodity
ces increased strongly, enterprises,
cially state enterprises rushed to
row capital from the banks to maintain
 production and business operations
 then stored commodities, waiting for
igher prices in order to get benefits. It
re the capital scarcer and the prices of
modities continued increasing.

Third, banks mainly loaned the state
conomy and the collective economy
the capital issued with the subsidized
nterest rate, meanwhile these clients used
capital ineffectively, requiring the
pensations for losses from the state
udget and contributing to the
verspending of the state's budget. In turn,
the budget overspending required to be
olved by issuing money. Therefore, the
olume of currency in circulation increased
sapidly.

The renovation in the condition that
the economy fell into serious economic
crisis, inflation was very high and the
ancial market was underdeveloped,
ade objective requirements for
ovating the banking system,
ansferring the one level banking system
uilt in 1951) to the two level banking
stem. When Decree No.53 (March, 1988)
was promulgated, together with the
novation model of the banking system,
e Central Bank determined and
plemented monetary policies, including
aying down as a policy the surplus real
nterest rate and considering the interest
te as an important tool of the monetary
olicy. At that time interest rate consisted
f two kinds: Subsidized interest rate and
eed interest rate. The subsidized
nterest rate facilitated enterprises to
ge dramatically into operation in the
arket mechanism. The agreed interest
te consisted of the agreed interest rate of
he specialized banks and the agreed
nterest rate of the non-state organizations.
This awareness renovation of interest rate
as significant to control the economy in
he market mechanism, implemented in
Vietnam. The interest rate was initially regarded as price of currency and was gradually determined by the market, thus, it manifested a signal in Vietnam’s credit market.

In reality from July in 1987 to February in 1989, the interest rate was adjusted twice in the direction of lessening subsidization dramatically through credit and inflation factor. The Governor director of the State Bank stipulated the agreed interest rate based on two principles: agreed loan interest rate was equal to the highest deposit interest rate (at that time it was 8%) plus additional bank charge (at that time was 0.3 – 0.4 %), thus the interest rates increased remarkably. This interest rate policy played an active role, avoiding the stituation of taking advantage of bank’s capital to store commodities and waiting for profits when the price of them increases, and freeing billions of commodity money considered stagnant. This policy also made enterprises to consider pluses and minuses, revoke capital and increase the circle of capital. Therefore, the price index dropped to 7.2 % per month in the last six months of 1988 and 5 % per month in the first six months of 1998.

Moreover, commercial banks dealt with interest rate unmethodically and raised the interest rate to the level that was higher than the guided one. In particular, the guided interest rate of the state bank on June 6th, 1988 was 8.3 %, but some banks implemented with the level of 8.4 %, commonly with 9 – 10 % and even 11- 12%. The competition of the units which dealt with money pushed the interest rates to a higher level. The interest rate applied in reality was too high, exceeded the capital of the market and caused the capital borrowing clients’ strong reaction. At the end of 1988, banks had to reject the agreed lending. From March in 1989, the government decided to change the interest rate policy fundamentally and accordingly there was a difference between the effective interest rate and the estimated interest rate. It is estimated that interest rate consisted of the basic interest rate plus the inflation rate. Detective No.55T dated March 13, 1989 of the Council Ministers assigned the Governor of the State Bank of Vietnam the right to determine the loan interest rate and adjust it to the fluctuation of market prices. This was a new progress in the awareness of interest rate in Vietnam, which allowed to use the interest rate more effectively. Thus, interest rate was regarded as a criterion that needed to be reckoned, implemented and laid out more actively. Decision No.39 / HDF dated on April 10, 1989 set up the bank’s fundamental principles on the interest rate and deposit interest rate as follows:

1) The interest rate must be enough to preserve the capital and profit.
2) A united interest is applied to economic sectors and adjusted to the fluctuation of market prices.
3) All the sources of capital mobilized by banks for loan get interest and
The interest rate of savings and the loan interest rate consists of the basic interest rate and the index of changes in market prices.

The principles above were implemented, from the situation that the interest rates lasted for many years, the interest rates became the surplus effective ones in 1989. Moreover, the interest rates were adjusted to the inflation rate (from March, 1989 to February, 1990 there were five times to adjust the interest rates). The policy of surplus effective interest rates, applied in Vietnam at that time, was significant in both theory and practice, which expressed the new awareness of the interest rate: the interest rate is not only a simple economic variable but also a tool to fight against the inflation effectively.

Since then, the inflation in Vietnam has been identified as resulting from many different causes, of which the most significant factor is monetary. Raising the interest rate of savings over the inflation rate was considered as a fundamental measure of the anti-inflation measures in his period. The surplus and high deposit interest rate ensured the money property of the public, which made the new circumstance emerge: Instead of storing commodities, the people kept their money in the banks for safe and steady profits. The United Nations, the International Monetary Fund and World Bank appreciated Vietnam's fight against inflation. The development programme report of the United Nations in December, 1989 stated: The measures to stabilize finance and money taken by the government of Vietnam in fighting against inflation were remarkably successful in 1989. In fact, to control inflation was the result of implementing many different measures and tools in controlling inflation, of which the effective contribution of the interest rate tool was primary.

In 1989, market prices grew on average by 2.5% / month (15% / month in 1988), the inflation was reduced from the three digit level in 1986, 1987 and 1988 to the level of 34.7% in 1989 and the two digit level of inflation remained until 1995 in the direction of bettering the high rate of inflation (14.4% in 1994, 12.7% in 1995).

However, the policy of surplus effective interest rate was absolutely implemented only in 1992 because in 1990, 1991, the happening of inflation was too complicated, which made the adjustment of interest rate impossible to catch up with the situation. It showed that the flexible application of the interest rate policy was not easy, which made the interest rate unsuitable to the fluctuation of inflation.

In general, Vietnam's inflation control before 1986 (mainly the fight against high inflation) created good conditions for the
economy to gain important achievements: GDP was twice as much as that before the renovation, the economy overcame the crisis, commodities became plentiful and diversified, material and spiritual life of the people was gradually improved.

From 1996, the price index always remained at one digit level, but the situation became complicated: the price index of 1996, 1997 was 4.5 % and 3.6 %, 1998, 9.2 %; 2000, - 0.6 %; 1999 and 2001, 0.1 % and 0.8 %. That situation placed Vietnam in a long lasting and strong deflation. If in 1996 the deflation lasted four months (from May to August) with the total deflation rate of 1.6 %, in 1999, the deflation continually lasted eight months (from March to October) with the total deflation rate of 4.4 %. In 2000, deflation was more complicated; however, it lasted five months (from March to July) with the total deflation rate of 3.4 % - not as much as that in 1999, but it showed more seriousness because the price level in the first months of 2000 was not as high as that in the same period of 1999 (2 % as compared with 3.6 %). That situation led to the general price base of the economy in 2000, which was much lower than that in 1999 (- 1.6 % as compared with + 0.1 %). In 2001, due to the government's measure of stimulating demand to aim at overcoming deflation (implementing the no-more- than - 5 % inflation objective proposed by the National Assembly), the economy couldn't overcome this situation: the deflation lasted three months successively (from March to June) and in 2001, the consumer price index grew by 0.8 %. Although the consumer price index in 2001 was higher than that in 2000, the economy was still in deflation and the economic growth didn't reach the target of 7.5 % per year as proposed by the National Assembly (only reached 6.8 % per year).

When analyzing the causes of the deflation, opinions were varied. In brief, the deflation resulted from economic mechanism and structure, low and uneven income of the public, ineffective investment and fluctuation in the world market. In 1997, the state put forward four groups of solution to stimulate the demand in the economy. In 1999, market prices tended to fall down sharply, thus the government's Resolution 08/ 1999 Q -CP continued bringing out seven solutions to fighting against deflation.

Of the solutions above, the state used the loosened monetary policy and actively renovated the interest rate policy in the direction of liberalization to improve the situation. The interest rate policy under this direction loosened the interference of the Central Bank and the liberalization interest rate was gradually implemented through many steps. From 1996, the interest rate was out of control under the interest rate maximum together with the average difference between the loan interest rate and the deposit interest rate. From August - 2002 to May - 2002, it was managed under the basic interest rate. Since June - 2002, the interest rate has been liberalized. Implementation of this interest rate policy...
to use the interest rate tool aiming at overcoming the deflation, the interest rate was continuously adjusted to stimulate the investment and consumption demand. The deflation lasted for a long time, so the Central Bank continuously reduced the interest rate: four times in 1996, twice in 1997, and five times in 1995. The repeated interest rate lowering in these years aiming at stopping the deflation didn't gain the result as expected, the deflation continued to get worse in the years of 2000 and 2001 (the price index in 2000 was — 0.6 % and in 2001 was 0.8 %). It showed that when investment was ineffective and consumption was not sensitive to interest rate, lowering interest rate wasn't effective enough to stimulate the demand. In 2002 and 2003, the deflation rate decreased, the norm of no more than 4% inflation as proposed by the National Assembly was fulfilled due to the implementation of various comprehensive solutions.

The situation became more unsolvable when from the beginning of 2004, inflation tended to grow. According to the figures of the Bureau of Statistics, particularly in February, 2004, the index of price increase in the market was 3 % (equal to the level of price increase of the whole year 2003). Generally calculating, in the first two months, it increased by 4.1 %, this has been the highest level of price increase of the first two months over the past ten years. If we calculated eight months of the year 2004, the level of price increase was 8.3 %, exceeding the planned norm of the whole year of 2004. The situation of price increase originated from many different causes such as the influence of the fluctuation of prices in the world market (petrol price and gold price in the world grew high continuously), the increase in the import price of nitrogen, the increase in steel price, and the bird flu epidemic in our country and in some others. The situation above happened while the whole country made an effort to implement the objective of high and solid economic growth in the period of 2001 and 2005, which posed a difficult question for the economic policy makers. The State Bank of Vietnam advocated maintaining the basic interest rate at 0.625 % per month, aiming at reaching the norm of economic growth of 2004, which is 7.5 % - 8%. However, the interest rates in the market tended to grow slightly, especially medium and long term interest rates.

It is possible to find that the inflation which has occurred since the beginning of 2004 is mainly due to the push of expenditure and the increase in the price of production factors, thus the measures of curbing inflation have to aim at controlling the prices of input commodities. Whatever the causes are, to overcome inflation, it is necessary to adjust the interest rate to the relationship between supply and demand for capital in the market.

3. Lessons from Experience

Through the reality of using the interest rate tool in controlling inflation in other countries and in Vietnam, some lessons are drawn from experiences as follows:
First, inflation results from various causes, so it is impossible to use interest rate in all cases as a tool to achieve the goal as expected.

Second, interest rate is a special kind of price, thus when used as the tool in controlling inflation, it should be carefully and fully considered. The determination of interest rate in each nation is different, but the common tendency in the market economy is to liberalize the interest rate when necessary.

Third, interest rate is one of the tools of economic policy in general and of monetary policy in particular; therefore, when used to control inflation, it is necessary to combine different tools together to get the best result.

Fourth, when inflation becomes complex, the interest rate should be carefully used in order to achieve the defined economic targets (do not allow the interest rate to be an obstacle to the implementation of other objectives).

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SỬ DỤNG CÔNG CỤ LÃI SUẤT TRONG KIỂM SOÁT LẦM PHÁT Ở VIỆT NAM

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Kiểm soát lạm phát là một trong những mục tiêu quan trọng nhất của mỗi nước. Để đạt được mục tiêu này, mỗi nước phải sử dụng nhiều biện pháp và công cụ khác nhau. Một trong những công cụ kiểm soát lạm phát phổ biến nhất là công cụ lãi suất. Trong thực tế, sử dụng công cụ này đã mang lại bài học thành công cho nhiều nước.

Việt Nam là một quốc gia đã thành công trong việc đẩy lùi lạm phát ba con số bằng cách sử dụng công cụ lãi suất vào cuối thập kỷ 80 của thế kỷ 20. Bằng cách thực hiện dàn dần công cụ này, từ 1986 đến nay, lạm phát được kiểm soát ở mức một con số.

Tuy nhiên, sử dụng công cụ lãi suất có hiệu quả vì mục tiêu kiểm soát lạm phát, hiện nay còn nhiều vấn đề cần phải giải quyết: từ bàn thân việc thực hiện công cụ lãi suất tối việt thực hiện nó và kết hợp với các công cụ và biện pháp khác.