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:

$$i = i_r + \Pi^e \quad (1)$$

$$\rightarrow \quad i_r = i - \Pi^e \quad (2)$$

i = interest

i_r: real interest

Π^e : 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 or 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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Fnce and Canada and they are also the nations which have the highest irrst rates; four nations which have low inton rate are Japan, Germany, Hand and Switzerland, and they are a he nations which have low interest res.

Ir brief, they admitted in theory and in pctce that the relationship between irrst rate and inflation is undeniable. It isne basis for using the interest rate tool icontrolling inflation in many different nois in modern economic circumstances.

Tie Federal Reserve System of the Ltd States of America (FED), together wi other tools, actively used the interest re ool in controlling inflation during the daces when the economy faced the inlable situation of inflation rate. In the yrs of 1979 and 1982, the inflation rate oAnerica was always at the two digit lels. By raising the discount rate to a hi evel in America's history (10.5 % in 10 and 11.5 % in 1981), and therefore, t iterest rate amounted to 13.36 % in 19 and 16.38 % in 1981, did FED reduce t inflation rate from 13.7 % in 1979 to 8% in 1980 and 6.1 % in 1981, 1982. In Fne, at the end of 1978, the economy f into the situation of two digit inflation uil 1981, 1982. In 1981, the Central Bk of France had to raise the discount re o 17.5% and the market interest rate t1.28% - the highest interest rate in Fne's history, in order to repel the iaton. Within only six months, the doint rate was raised twice as much as tt n 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. If the salary in circulation in 1976 is considered as the survey market, it increased by 2.2 times in 1980; 29.9 times in 1985; 131.1 times in 1986; 548 times in 1987. The amount of money issued in circulation was so high that it made the 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 and branches. Thus, at that time there was renovation in the view and way of acknowledging inflation. From then on, the measures of fighting against inflation were defined, associating with the steps of implementing the economic renovation such as carrying out the market price mechanism, widening the self-control rights of enterprises, reforming economic policies etc. Especially, the reform of financial and monetary policies and using the tools of monetary policies, 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 in product prices, and return of bank expenses. Because of such a point of view, interest rate was not considered as a kind of price and thus it was not used as an economic tool. The interest rate policies during this time period mainly had a political aim and content, describing the discriminatory treatment between economic

·cors and units and showing the state's ıbidization to the state enterprises. specially, it is the real interest rate that as minus, thus the interest rate ·ecribed by the state was always lower ıaı zero for a long time. With such terest rate policies, interest rate orened inflation.

First, interest rate did not encourage ıe saving in the economy. In 1993, if a ieıt kept 1000 VND in the bank, the ılıe of that sum of money would be ıuvalent to about 700 VND; similarly, in)8ì it would be equivalent to only)0'ND. With low income, the households 'ietnam only had a very little amount savings, they couldn't allow that sum of oiey to devalue when keeping it in the ın:, so they often used that amount of oiey to buy commodities, gold and hard rencies. As a result, the prices of mmodities of different kinds were oving and inflation was worsened.

Second, the minus interest rate nefited the capital borrowing terprises. In the condition that mmodities were scarce and commodity ices increased strongly, enterprises, pecially state enterprises rushed to rrow capital from the banks to maintain eı production and business operations ıd then stored commodities, waiting for e ıigher prices in order to get benefits. It ace the capital scarcer and the prices of mmodities continued increasing.

Third, banks mainly loaned the state n economy and the collective economy the capital issued with the subsidized interest rate, meanwhile these clients used capital ineffectively, requiring the compensations for losses from the state budget and contributing to the overspending of the state's budget. In turn, the budget overspending required to be solved by issuing money. Therefore, the volume of currency in circulation increased rapidly.

The renovation in the condition that the economy fell into serious economic crisis, inflation was very high and the financial market was underdeveloped, made objective requirements for renovating the banking system, transferring the one level banking system (built in 1951) to the two level banking system. When Decree No.53 (March, 1988) was promulgated, together with the renovation model of the banking system, the Central Bank determined and implemented monetary policies, including laying down as a policy the surplus real interest rate and considering the interest rate as an important tool of the monetary policy. At that time interest rate consisted of two kinds: Subsidized interest rate and agreed interest rate. The subsidized interest rate facilitated enterprises to change dramatically into operation in the market mechanism. The agreed interest rate consisted of the agreed interest rate of the specialized banks and the agreed interest rate of the non-state organizations. This awareness renovation of interest rate was significant to control the economy in the 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 freeding 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 dal with money pushed the interest rate o higher level. The interest rate apple i reality was too high, exceeded the capait of the market and caused the capta borrowing clients' strong reaction. At th end of 1988, banks had to reject the agre lending. From March in 1989, th government decided to change the intee rate policy fundamentally and accordigl there was a difference betweer th effective interest rate and the estimate interest rate. It is estimated that intee rate consisted of the basic interes a plus the inflation rate. Detective No.55T dated March 13, 1989 of the Counc Ministers assigned the Governor of th State Bank of Vietnam the right determine the loan interest rate ar adjust it to the fluctuation of mak prices. This was a new progress in th awareness of interest rate in Vietnar which allowed to use the interest rate to more effectively. Thus, interest rate w regarded as a criterion that needed t reckoned, implemented and laid ow more actively. Decision No.39 / HĐI dated on April 10, 1989 set up the sa bank's fundamental principles of o interest rate and deposit interest rat follows:

1) The interest rate must be enough preserve the capital and profit.

2) A united interest is applie economic sectors and adjusted to t fluctuation of market prices.

3) All the sources of capital mobiiz by banks for loan get interest and eve

nount of money loaned by banks is paid nerest.

4) The difference between the loan nerest rate and the interest rate of savings on average is 0.5 % per month.

5) The structure of the interest rate of savings and the loan interest rate consists of the basic interest rate and the index of slippage in market prices.

The principles above were mplemented, from the situation that the ninus interest rates lasted for many years, he interest rates became the surplus effective ones in 1989. Moreover, the nerest rates were adjusted to the nlation 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 he new awareness of the interest rate: the nerest rate is not only a simple economic variable but also a tool to fight against the nlation effectively.

Since then, the inflation in Vietnam has been identified as resulting from many lifferent causes, of which the most significant factor is monetary. Raising the nerest rate of savings over the inflation ate was considered as a fundamental neasure of the anti-inflation measures in his period. The surplus and high deposit nerest rate ensured the money property of the public, which made the new ircumstance emerge: Instead of storing ommodities, 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 (it only reached 6.8 % per year).

When analyzing the causes of the deflation, opinions were varied. But in brief, the deflation resulted from economi mechanism and structure, low and unever income of the public, ineffectiv investment and fluctuation in the world market. In 1997, the state put forwar four groups of solution to stimulate th demand in the economy. In 1999, marke prices tended to fall down sharply, thu the government's Resolution 08/ 1999 Q -CP continued bringing out seve solutions to fighting against deflation.

Of the solutions above, the state use the loosened monetary policy and active renovated the interest rate policy in th direction of liberalization to improve th situation. The interest rate policy und this direction loosened the interference the Central Bank and the liberalization interest rate was gradually implement through many steps. From 1996, th interest rate was out of control under th interest rate maximum together with th constraint of the average differen between the loan interest rate and th deposit interest rate. From August - 20 to May - 2002, it was managed under t basic interest rate. Since June - 2002, t interest rate has been liberalized. In t implementation of this interest rate poli 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 LẠM 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 các sử dụng công cụ lãi suất vào cuối thập kỷ 80 của thế kỉ 20. Bằng cách thực hiện dần dần công cụ này, từ 1986 đến này, 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 bản thân việc thực hiện công cụ lãi suất tới việc thực hiện nó và kết hợp với các công cụ và biện pháp khác.