

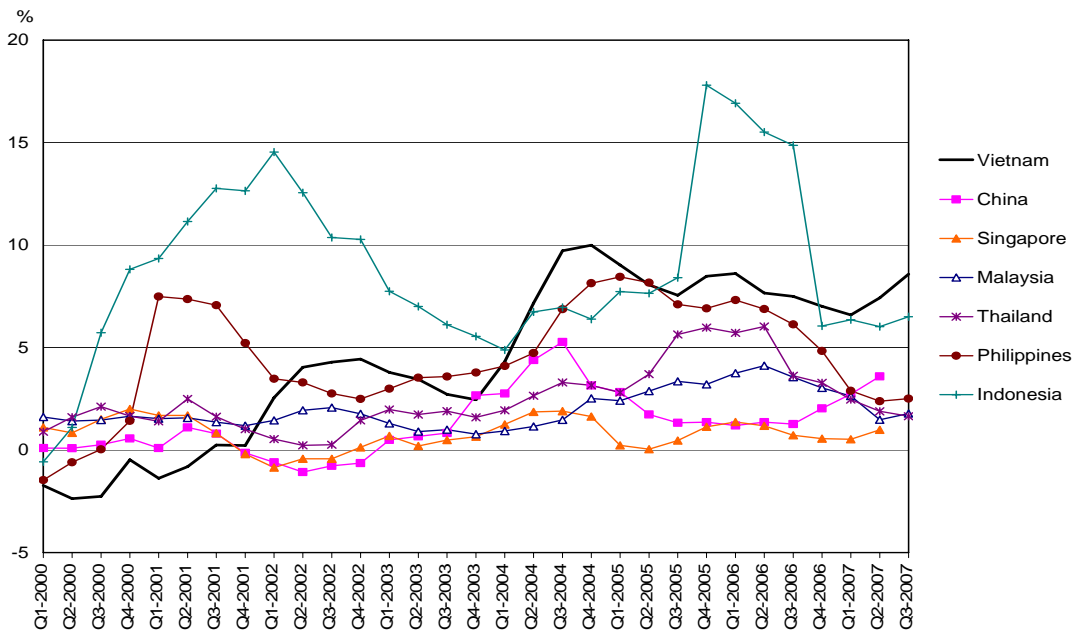
Chapter 5

Rising Inflation

The inflation puzzle

Let us start by asking this question: why has Vietnam's inflation been higher than most neighboring countries in recent years? After the very high inflation ended in the early 1990s, general prices in Vietnam remained stable with an average consumer price inflation of 3.1% during 1996-2003. However, in 2004 it jumped to 9.5% and has stayed relatively high ever since. In 2007, it rose to 12.6%. One may argue that annual inflation of around 10% is not a macroeconomic disaster and perhaps even tolerable if the real economy continues to grow strongly. However, it is important to understand the causes behind Vietnam's current inflation in order to identify background macroeconomic forces at work and anticipate future risks.

Figure 5-1 Consumer Price Inflation



Source: IMF, *International Financial Statistics*, various issues.

As illustrated in Figure 5-1, from 2004 to 2007, inflation in Vietnam has been higher than in the neighboring countries except Indonesia, a country facing serious political and economic problems. At present, Vietnam has the highest inflation among East Asian high performers. Although high prices of oil and other commodities are certainly to blame for part of the price increase, inflation differential between Vietnam and other countries cannot be explained by such globally common factors. Similarly, SARS, bird flu, and other epidemics pushed up food prices in Vietnam, but neighboring countries also experienced these predicaments. Although external causes cannot be ignored, we need an additional explanation for Vietnam's specific situation.

An issue paper by the International Monetary Fund (IMF, 2006b) conducts several statistical analyses to arrive at rather ambiguous conclusions that (i) monetary factors appear to have become an important determinant of Vietnam's inflation over the last few years; (ii) food and oil price shocks seem to persist longer in Vietnam than in other Asian countries; and (iii) there is no strong evidence of the Balassa-Samuelson effect, or the productivity-driven increases in the prices of nontradables relative to tradables¹. However, these conclusions are not sufficient to construct concrete policy advice. We would like to present a more structural story of how Vietnam's inflation occurs, which is also consistent with these IMF findings.

External injection of purchasing power

Inflation is basically a monetary phenomenon. Persistent inflation occurs by an injection of purchasing power into the economy beyond its absorptive capacity. It is empirically well known that excess liquidity usually stimulates both output (temporarily) and prices. But it is important to distinguish the case in which this liquidity injection occurs internally and the case in which it comes from external sources.

The classical balance-of-payments crisis of the 1960s-80s, in which IMF played a crucial role, starts with an irresponsible government which over-spends its revenue. The resulting fiscal deficit is financed by printing money. This increases domestic credit and money supply, and creates inflation. On the balance of payments, the current account worsens and the capital account also deteriorates as the country sinks deeply into debt until no one lends money to this country. The monetary authority runs out of international reserves to pay for imports and debt repayments. The country has no option but to go to IMF and ask for an emergency loan in exchange for the monitored execution of belt-tightening macroeconomic measures.

However, as an increasingly large number of developing countries open up to capital inflows, another type of macroeconomic problem emerged in the 1990s. As a country liberalizes its capital account, foreign investors are aroused and begin to invest aggressively in that country. They often follow herd behavior under the condition that information is imperfect and domestic financial markets are primitive and not properly regulated. Foreign funds may come in the forms of bank loans, stocks, bonds, real estate purchases, and so on. FDI, remittances, and even ODA may also be attracted to a country which is rumored to be a rising star. As these funds are received, there will be broad repercussions in the macroeconomy through the usual Keynesian multiplier effect. This generates consumption and construction booms as well as land and stock market speculation. Goods markets and asset markets reinforce each other to sustain the overheating. This is the situation that Vietnam and China are experiencing at present.

The macroeconomic symptoms of *irrational exuberance* include strong growth, accelerating inflation, rising international reserves, and gradual overvaluation (the loss of international price competitiveness). This mix is troublesome enough, but the real risk is the possibility of serious crisis if this situation proceeds too far. A severe reversal may occur as asset markets

¹ The Balassa-Samuelson effect assumes an economy consisting of two sectors, the tradable (typically manufacturing) and the nontradable (typically services). If productivity grows faster in the first sector than the second, if factor markets such as labor are integrated between the two sectors, and if the prices of tradables are given by global trends, it can be shown that domestic inflation is proportional to the productivity gap between the two sectors. Such inflation is regarded as benign because it reflects changes in the real sector rather than macroeconomic policy failure.

collapse, foreign investors leave the country, the currency plummets, bad debt mounts, and credit crunch emerges. This type of crisis, caused by an excessive inflow of foreign funds and their subsequent withdrawal, is called the *capital-account crisis*, as opposed to the traditional *current-account crisis* generated by loose fiscal policy (Table 5-1). The Asian financial crisis of 1997-98 was a typical capital-account crisis (Figure 5-2), but Vietnam was not directly hit by it because its capital account was closed at that time². To be not too alarmist, however, it should be stressed that such a disaster is not inevitable. Even with continued capital inflows, serious crisis may not develop and the economy may suffer only from mild inflation and mini asset bubbles. Outcome depends on the size and nature of capital inflow as well as the appropriateness of policy response.

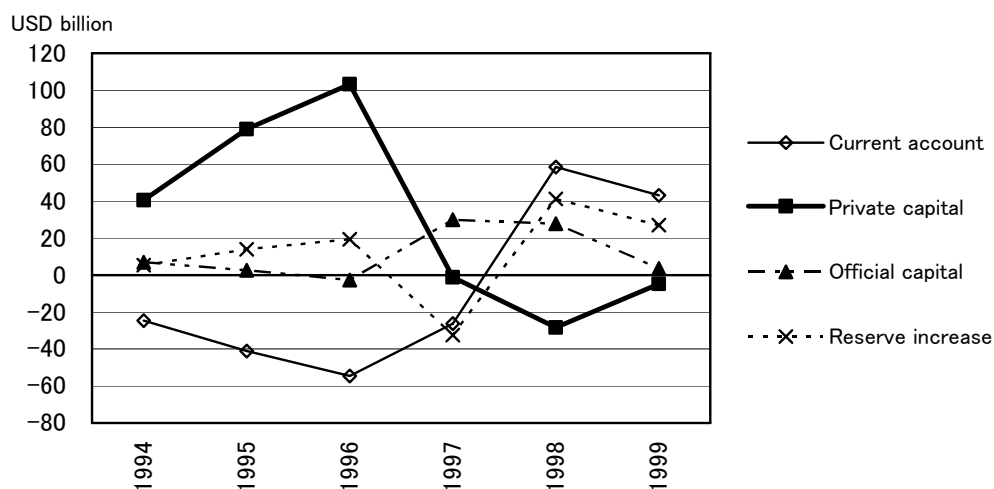
Table 5-1 Comparing Two Crises

	Classical Crisis (Current-account Crisis)	New Crisis (Capital-account Crisis)
Source of purchasing power	Internal (budget deficit)	External (capital inflow)
Initial spending increase	Public sector	Private sector
Private output and investment	Crowded out	Expands strongly*
Inflation	Rises	Rises
Banking crisis	Possible	Possible
Asset market bubble (land and stocks)	Rare	Likely*
Current account	Worsens	Worsens*
Capital account	Worsens	Improves*
International reserves	Decreases	Increases*
Exchange rate	Overvaluation	Overvaluation*
Remedy	Macroeconomic austerity	Proper management of capital inflow and its use

Note: the asterisk indicates the possibility of subsequent reversal (see Figure 5-2).

² The serious mistake that IMF made at the time of the Asian financial crisis was to prescribe current-account crisis solutions (tight budget and money coupled with high interest rates) to economies suffering from a capital-account crisis, which aggravated the situation and prolonged the crisis. See M. Yoshitomi and K. Ohno, "Capital-Account Crisis and Credit Contraction: The New Nature of Crisis Requires New Policy Responses," ADB Institute Working Paper no.2, May 1999; J. E. Stiglitz, *Globalization and Its Discontents*, W.W. Norton & Company, 2002; and International Monetary Fund Independent Evaluation Office, *The IMF and Recent Capital Account Crises: Indonesia, Korea, Brazil*, 2003.

Figure 5-2 Consolidated Balance of Payments of Five Asian Crisis-hit Countries



Source: Compiled from Institute for International Finance, “Capital Flows to Emerging Market Economies,” Sep.29, 1998 and Jan.27, 1999.

Note: The sum of the balance of payments of Korea, Malaysia, Thailand, Philippines, and Indonesia.

Vietnam is receiving a large sum of foreign funds every year, amounting to about USD15 billion or 25% of GDP as of 2006³. Inflows in 2007 seem to have increased further. With such inflows, all macroeconomic symptoms of the early stage of capital-account crisis are visible, except overvaluation (see below). Real GDP continues to grow at above 8%, inflation has surpassed 10%, nascent stock markets are booming with intermittent corrections, urban land prices are skyrocketing, and international reserves, which are not publicly announced, seem to be increasing.

It is difficult to predict if Vietnam will experience a severe “reversal,” such as the baht crisis in 1997, in the future. But macroeconomic authorities are well advised to monitor the situation and take precautionary measures as necessary to minimize such a risk. The international lessons learned at the time of the Asian financial crisis are particularly useful to review (see the last section).

Traditionally, the problems associated with an excessive receipt of foreign exchanges have been analyzed in the context of the *Dutch Disease*. The Dutch Disease is a phenomenon in which a country suffers from overvaluation and de-industrialization as a result of an expansion of an extractive sector such as oil, gas, and minerals. Discovery of new mines as well as global commodity booms can cause this situation. Under the current high prices of energy and other natural resources, many commodity exporting countries such as the UK, Russia, Kazakhstan, South Africa, Nigeria, Botswana, and Zambia are “enjoying” the Dutch

³ The precise amount of “inflow” is difficult to pin down due to ambiguous definition, conflicting data, and under-reporting. Note that the data must be on actual payment basis, not commitment or approval basis which is always larger than implementation. The numbers in the text are obtained by adding up the following statistics and estimates for 2006 (gross and actual payment basis): nonfactor services (mainly tourism), USD4.7 billion; private transfers (Viet Kieu and workers’ remittances), USD3.5 billion; FDI, USD2.2 billion; ODA grants, USD0.2 billion; ODA loans, USD1.8 billion; bonds and stocks, USD2.5 billion. The sum of the above is USD14.9 billion.

Disease. The macroeconomic consequences of the Dutch Disease are similar to those of the capital-account crisis, except that the latter involves a higher risk of severe shocks and sharp reversals due to the financial nature of the crisis. Vietnam's economic boom is fueled mainly by investment and capital inflows but an increase in oil revenue also contributes to it.

At present, a large number of countries, including Vietnam, are experiencing economic booms caused by foreign exchange inflows associated with strong investment or commodity inflation. Vietnam's current inflation should be understood not as an isolated phenomenon but as an internationally common phenomenon. This point must be grasped correctly to avoid misdiagnosis and mistreatment of the problem.

Fiscal activism

While receiving a large amount of external funds is the root cause of the current inflation, it is not the only cause. Fiscal activism is an additional internal factor which accelerates the economic boom created by the injection of external purchasing power.

Supported by strong economic performance, the Vietnamese government has ambitious plans to upgrade the country's infrastructure. Sustaining high growth is a top priority and any sign of slowdown is met by renewed efforts to accelerate public investment projects and secure their inputs by any means. According to GSO, the budget deficit amounted to 5% of GDP in 2006 and is increasing.

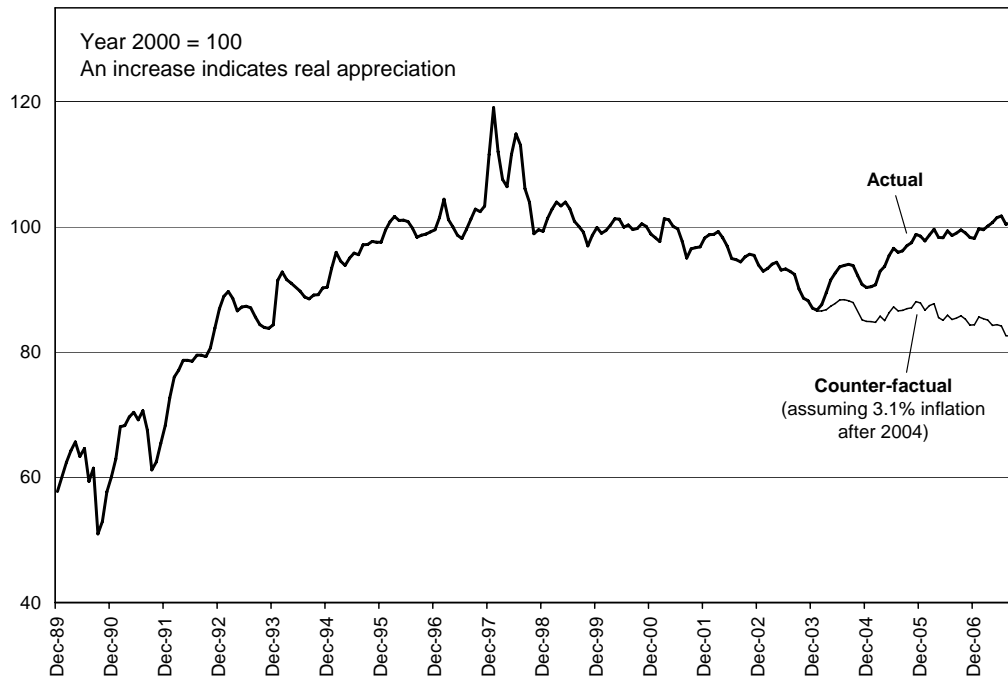
Pro-cyclical fiscal spending has also been observed elsewhere including Indonesia and a number of resource-rich Latin American countries such as Mexico and Brazil. As the economy grows strongly, public investment is also expanded to provide necessary infrastructure and diversify economic structure. However, risks associated with such policy should be well recognized. Aggressive spending may lead to huge indebtedness and economic crisis when the situation turns around. Both commodity markets and investor psychology are known to fluctuate wildly over time. Countries with externally driven booms should install mechanisms to smooth these swings, including a public fund to save windfall revenues for rainy days.

In sum, current inflation in Vietnam should be understood as the consequence of three combined forces: (i) pressure from the large inflow of foreign funds (main cause); (ii) aggressive public investment; and (iii) exogenous and largely uncontrollable shocks from global commodity markets, animal diseases, and natural disasters.

No overvaluation?

One puzzle concerning Vietnamese inflation is the apparent lack of overvaluation. Exchange rate overvaluation is usually measured by the *real effective exchange rate* (REER), an exchange rate against multiple trading partners adjusted for their inflation relative to the home country's. In essence, REER is an overall index of international price competitiveness with weights reflecting the importance of each trading partner.

Figure 5-3 The Real Effective Exchange Rate



Sources: VDF calculation using IMF's *International Financial Statistics* (exchange rates and CPI), GSO's trade statistics (trade weights), and data from the Central Bank of the Republic of China (Taiwanese data).

Note: Monthly exchange rate and CPI data are used to compute Vietnam's trade-weighted, inflation-adjusted index of international price competitiveness. Twenty-one largest trading partners, accounting for 90.0% of Vietnam's total trade in 2000-2005, were considered. Russian data were omitted for the period prior to January 2000 to purge the effects of hyperinflation and the ruble crises.

In Figure 5-3, the REER index is computed from the monthly price and exchange rate data of Vietnam and its 21 largest trading partners. Vietnam's REER was on a rising (appreciating) trend until 1997-98 when the Asian financial crisis broke out. During this crisis, Vietnam's REER was pushed up temporarily as the currencies of most neighboring countries fell relative to VND. Subsequently, the REER of VND declined (depreciated) moderately until 2003 then rose (appreciated) modestly until 2007. The IMF Staff Report stated in 2006 that "[t]he CPI-based real effective exchange rate fluctuated significantly over the last few years without exhibiting any noticeable long-term trend." (IMF, 2006a, p.30) If Vietnam is going through an economic boom caused by external capital inflows, why is overvaluation not detected?

The answer is the real depreciation of the US dollar. From the peak of March 2002 to end 2007, the REER index of USD declined about 20%. The overvaluation of VND, which is closely tied to USD, should be measured against this declining trend of USD. As the counterfactual calculation in Fig. 3 shows, Vietnam's REER index should have continued to fall if Vietnam had maintained the inflation rate of 3.1%, which was the actual average rate during 1996-2003, after 2004. Relative to this trend, VND was already overvalued 22% in September 2007. The apparent lack of overvaluation is therefore spurious. The Vietnamese dong is already overvalued, but this fact is camouflaged by the falling US dollar.

Policy response

As an increasing number of countries face the syndrome of excessive capital inflows, some lessons should be recalled from the painful experience of capital-account crises in the 1990s and the early 2000s. The most important thing is that the macroeconomic situation must be diagnosed correctly as being caused by capital inflows, not as a purely domestic malaise or a current-account crisis. This is necessary to avoid wrong measures that would aggravate the situation.

Fiscal and monetary policy should be managed to lean against the private-sector wind rather than toward it. That means that moderately tight macroeconomic policy stance is appropriate while capital flows in. If, unfortunately, a big reversal occurs and domestic demand begins to shrink, policy stance should be revised quickly to be more expansionary. In this regard, Vietnam's current fiscal spending is overgenerous given the already strong private-sector demand and the soaring land market. The IMF's advice to tighten fiscal and monetary policies is appropriate (IMF 2007).

Asset markets such as land and stocks should be monitored carefully and restrictive measures should be introduced if there is evidence of speculative bubbles. Between the land and stock market, the former moves more slowly while the latter, driven by short-term market psychology, exhibits more volatility. For this reason, the monetary authority may consider accepting moderate corrections and mini-crashes in the stock market rather than trying to prop up the prices when they want to fall. This is necessary to avoid making a small bubble into a gigantic one, for which soft landing is very difficult.

As for exchange rate management, there is no good advice that VDF can offer. In countries receiving a large amount of capital, such as Vietnam and China today and Thailand in the early 1990s, the home currency is under constant market pressure to appreciate. However, exporters often demand depreciation to offset domestic price and wage inflation and regain competitiveness. Caught in this dilemma, the monetary authority usually chooses to keep the exchange rate nominally fixed or almost fixed, by intervening in the foreign exchange market and buying up USD. This leads to a rise in international reserves and, in the absence of complete sterilization, an expansion of domestic credit and money supply. This is another channel that sustains the domestic boom and inflation.

Should VND be floated or at least made more flexible? It is reported that the State Bank of Vietnam is pursuing a roadmap toward a more flexible exchange rate regime, and IMF strongly supports it⁴. However, it is not clear what this policy implies for the movement of VND. First of all, the Vietnamese foreign exchange market is too shallow and primitive relative to the size of global capital markets. The authorities should have the ability to curb speculation and volatility when Vietnam liberalizes currency trade ("fear of floating"). Second, after floating, whether VND should appreciate or depreciate is not clear as both would produce negative effects (further loss of competitiveness versus further booms and inflation). To say that everything should be left to the market, including any volatility or misalignment that comes with it, does not sound like good advice to a transition economy.

⁴ "[G]oing forward, greater exchange rate flexibility would encourage improved management of exchange rate risk, and protect external stability, as the economy opens itself to global competition and private capital... the current strength of the external position offers a window of opportunity for the adoption of early measures to enhance exchange rate flexibility" (IMF, 2006a, p.12). The IMF's appeal for exchange rate flexibility is repeated at the Consultative Group meeting in December 2007 (IMF 2007).

After all, it is difficult to find a satisfactory solution as long as the root cause of the unwanted boom and inflation, namely large capital inflows, is not directly addressed.

Finally, the most useful lesson from the recent currency crises appears to be that capital flows should be properly monitored, and regulated if necessary, in the process of capital-account liberalization. This is a double-edged sword, because too much control would scare foreign investors and result in lost opportunity in mobilizing foreign savings. Vietnam should begin to study concrete policy options to stabilize capital inflows and manage capital-account crisis risks without sacrificing its development potential.