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## **The inflation of Vietnam in transition**

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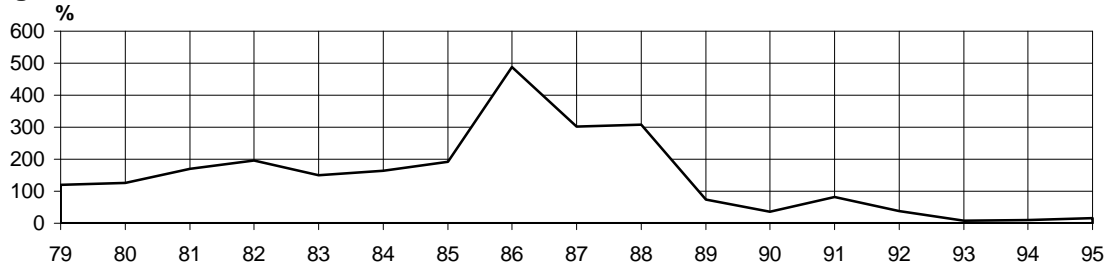
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## 1. Introduction

In Vietnam, sharp fluctuations of inflation in a decade raises a very interesting issue to the economists. Since the initial 1980 reform wave, inflation started to climb up and to peak at nearly 500% in 1986 (figure 1), after which it dramatically went down.

**Figure 1: Vietnam's General Price Index, 1979-1995**



Source : Adapted from Tran Hoang Kim, 1994 and WB, 1994 & 1996 Reports

The paper endeavours to identify and point out the causes and effects of inflation based on both Structuralist and Keynesian positions. Throughout the paper, a main theme is that monetary policy is passive in Vietnam. Monetary expansion is not the unique fundamental cause of inflation. However, deposit rate and credit control may be applied to fight inflation without support to the monetarists in case the financial system is very underdeveloped. The paper aims to answer the research following questions :

- What are the causes and determinants of inflation in Vietnam in 1985-1995?
- What has been the role and the impact of monetary policy on inflation in this period?
- What are the lessons and policy implications for Vietnam?

The paper argues that monetary expansion is not the only cause of inflation of Vietnam and will therefore employ both the Neo-Keynesian and the Structuralist theories to look into the causes and effects of inflation of Vietnam in a length of decade.

## 2. The overall outlook of Vietnam since the initial reforms

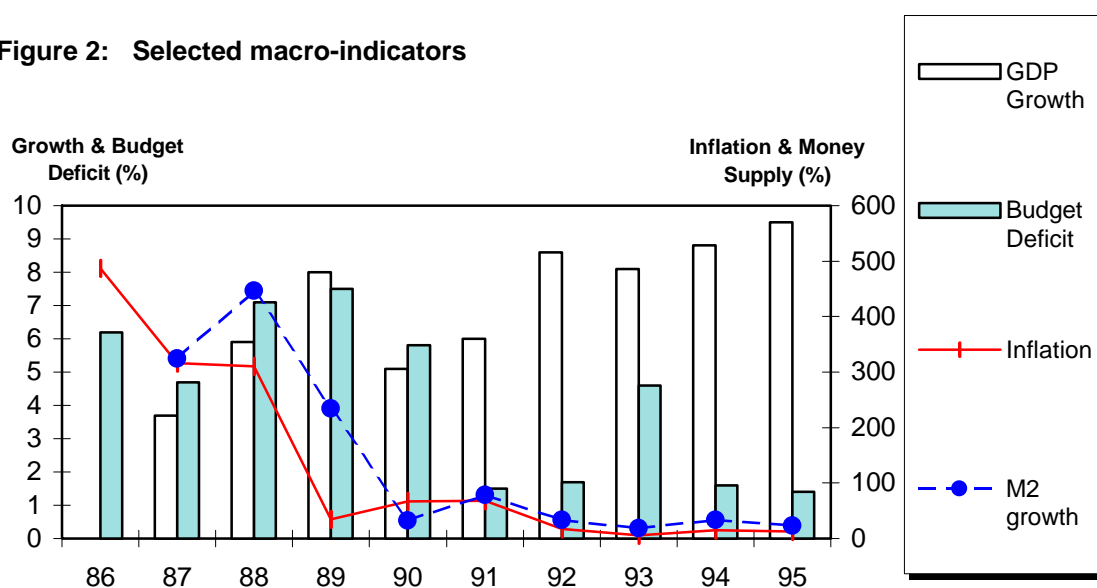
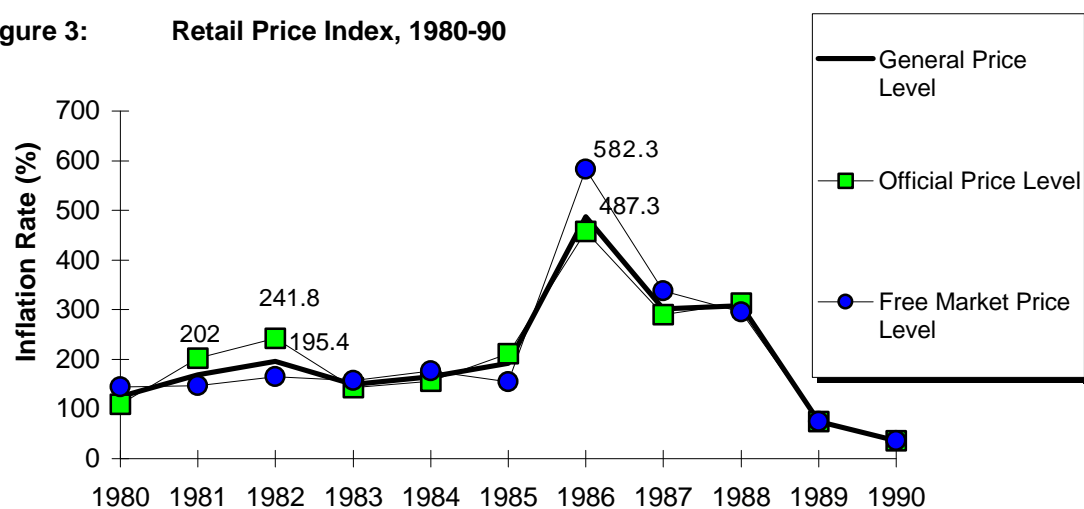
After stagnation, earlier in the 1980s, Vietnam embarked on initial reforms. Since then, inflation has fluctuated tremendously, as presented in Figure 2 and 3.

Based on the reform waves, the transition in Vietnam might be divided into the following sub-periods : 1980-1984, 1985-1989, 1990-1995. This division is consistent with the fluctuations of inflation in Figure 2. The first period 1980-1984 will not be reviewed in depth here due to the shortage and low quality of data available.

**Table 1: Share of GDP and Total Employment by Sector (in percentage)**

	1986	1987	1988	1989	1990	1991	1992	1993	1994
<b>Share of GDP</b>									
* by Industrial origin									
Agriculture	36.4	39.2	44.8	40.8	37.5	39.5	33.0	28.8	27.7
Industry	30.6	29.7	25.5	24.2	23.9	24.8	28.2	30.0	30.7
Services	33.1	31.1	29.7	35.0	38.6	35.7	38.8	41.2	41.6
* by Economic Sector									
- State	37.6	35.8	32.5	33.2	32.5	33.3	36.2	39.2	40.2
- Non-State	62.4	64.2	67.5	66.8	67.5	66.7	63.8	60.8	59.8
<b>Employment</b>									
State Sector	14.7	14.6	14.2	13.1	11.3	10.2	9.3	8.9	
Co-operative	72.0	72.5	72.5	68.2	67.4	58.3	58.5		
Non-State	13.3	12.9	13.2	18.6	21.3	31.5	32.1		

Source : GSO, 1994

**Figure 2: Selected macro-indicators****Figure 3: Retail Price Index, 1980-90**

Source : WB, 1994, Vietnam Public Sector Management &amp; Private Sector Incentives

## 2.1 The period 1980-1984

After the economic crisis in 1979, excess demand appeared to continue intensely. There was an increasing requirement for building a dominant industrial sector, particularly heavy industry. The border wars and domestic high population growth induced an increasing demand for food and other commodities. As supply was stagnated, the progressive rulers believed measures to raise output were in need. As Mc Carty reported, the early 1980s experienced initial economic reforms. These reform attempted to co-integrate the planned market with the parallel markets to stimulate supply. In addition, farmers were allowed to sell a part of their product to the State at negotiable prices (Mc Carty, 1994: 1). Though the reforms were not implemented comprehensively, they led to the output and production recovery in 1982. However, the monetary policy accommodating to the adjustment of the official prices gave rise to an open inflation. The general price index pushed up to nearly 200% as a result of the sharp increase in the official prices. The conservative authorities succeeded in returning the economy to the Stalinist compulsory model. As a result, inflation reduced slightly but output also dropped in 1984.

In the classical socialist model, the increase in the general price level was effectively dampened by the administrative setting of prices in spite of macro-economic excess demand. Administrative pricing was maintained to ensure price stability, which was considered as the superiority of the socialist system. In this system, inflation could generate from the free market and the official market, but the official prices only rose when the official prices of key inputs were set much lower than the free market prices, so that the government was unable to obtain their supplies. If the free market was weak, demand for goods might be suppressed via rationing mechanisms, which was termed as the phenomenon of “currency inconvertibility”. A type of forced savings was introduced to the households, when unspent and unspendable money was accumulated and made up the “monetary overhang”. It gave rise to a repression of inflationary pressures (Kornai, 1992: 548). This explained why the inflation was below 10% in four socialist countries before their reforms (Table 2).

**Table 2: Inflation of Socialist Countries in the Reform Process**

Period	China	Hungary	Poland	Yugoslavia	Vietnam
1960-80	-	3.7	5.0	-	-
1965-80	0.0	2.6	-	15.3	-
1966-70	-	-	-	-	2.3
1971-75	-	-	-	-	0.7
1976-80	-	-	-	-	21.2
1981-85	3.5	6.8	35.8	49.6	164.9
1986	6.0	5.3	18.0	88	487.2
1987	7.3	8.6	25.3	118	316.7
1988	18.5	15.5	61.3	199	310.9
1989	17.8	17.0	244.1	1,256	34.7

Source : Adapted from Kornai, 1992, Table 23.4, The Socialist System

When the socialist countries were on the transition to market oriented system in the 1980s (except China in 1978), the administrative barriers on price setting were removed. Price liberalisation entailed a release of price-raising force and thus spurred the upward movement of prices. The repressed inflation was converted partly or wholly into open inflation. The open inflation, in turn, induced both input prices to increase and wage earners to struggle more aggressively for higher salaries. The result was

cost-push effects like the wage-price spiral. Yet it was not the end of the story. Inflation and the shortage of goods resulted in a self-reproducing mechanism: both firms and household tried to keep reserve stocks of articles in short supply (Kornai, 1992: 551). A vicious circle of accelerating, inflation set in, with price rises even at three or four digit level as in the cases of Poland and Yugoslavia in 1989 (Table 2).

However, the inflation in Vietnam was less repressed in this period. As the free market in Vietnam was not insignificant and the government could not fully control production, shortages of goods spurred prices up wards in this market. The government had to raise the official prices to acquire the necessary goods. Official retail prices were raised by 10-15 times. The wholesale prices, which had remained unchanged for over 20 years, rose up by 7-10 times (Vo Dai Luoc, 1994: 116). Budget spending increased in nominal terms and was accommodated by money creation. In addition, the importance of the free market entailed a path for households to evade the “forced savings”. It led to the build-up of a household monetary circuit rather than to a monetary overhang. Besides, the involvement of SOEs in “out-of-plan” activities entailed cash transactions outside the banking system (Mc Carty, 1994: 5). The failure to control this money circuit might give rise to an acute inflation. None the less, the strict rationing and administrative pricing system, especially in 1983-1984, deterred the increased demand for goods. The aggregate inflation in the period 1980-1984 consequently stayed in the range of 100-200%, though harmful but not acute and problematic as in the following period.

## 2.2 The period 1985-1989

In 1985 a reform package called the *General Adjustment of Price, Wage and Money* was introduced. At the time, reform designers tried to improve the terms of trade of the agriculture sector because the government extraction of the agricultural surplus was discouraged by too low plan prices compared to market prices. The primary policies of this reform were as follows:

- planned prices were pegged to market prices, hoping this would encourage production and the collection of the agriculture surplus.
- monetisation of public workers' income to abandon the rationing system, thus raising their standard of living.
- currency redenomination was introduced in an attempt to destroy the excessive cash holdings of households.
- increases of loans for SOEs to offset the adverse affect of currency reform.

The Adjustment removed the rationing system and thus monetised the households' incomes. As the nominal income increased, demand for goods pushed up. The currency redenomination adversely affected on the state sector. Public firms became short of cash and funds for ordinary operation, and the government had to fill the gap because of the soft budget constraints. Other direct fiscal expenditures, e.g. wage rises for public workers, worsened the budget deficit. The coverage ratio of revenue to total spendings fell to 55% in 1985 from 81% in 1984. The budget deficit became large as a result of these expenditures and the credit growth. On the expenditure side, the state budget was considered the “milkcow” of inefficient State-owned Enterprises (SOEs). On the revenue side, the government

failed to make a budget buoyancy. Again, monetary policy was accommodating the problems of fiscal deficits.

Runaway inflation in Vietnam in the late 1980s may be attributed firstly to the removal of repressed demand. The increase and monetisation of income led to a soaring aggregate demand in the real market which was confronted with the inelasticity of aggregate supply. When monetary policy was allowed to accommodate the planned growth targets, sky-rocketing inflation was of little surprise. The aftermath was as follows: within a year after the Adjustment, inflation soared to its peak in 1986. Once inflation increased at such a high rate, expectations of very high inflation induced the economic agents to increase their hoarding and speculation of goods to protect their position. Excess demand rose, thus intensifying the instability. As a result, inflation was acute in the 1986-1988 (Figure 3).

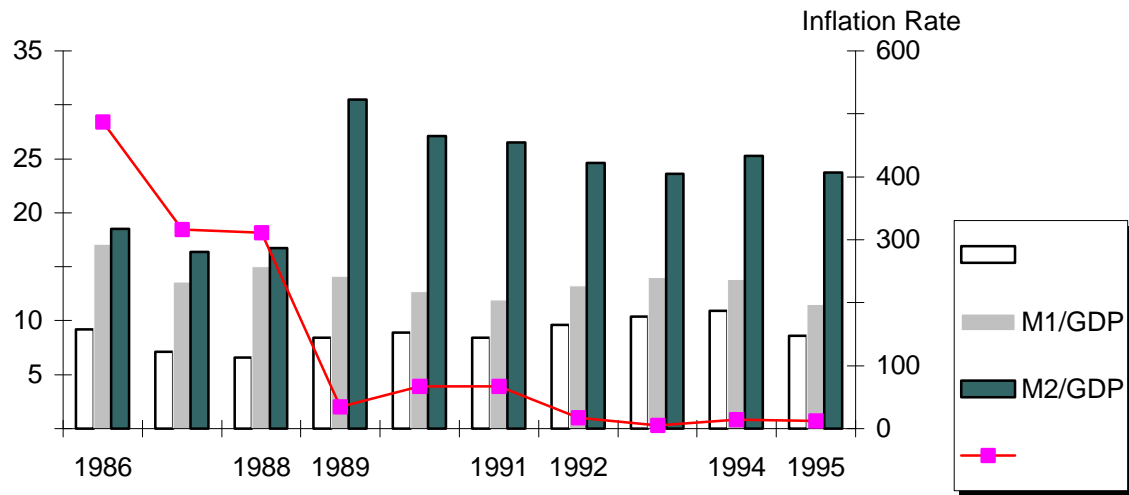
As the financial system was hardly developed, the effectiveness of deposit rates as a stabilisation tool was in little dispute (Jansen, 1995, P.28). This justified the success of the 1989 stabilisation programme. Moreover, a combination of various supply-side policies offset the adverse effects of the use of this instruments. The results were striking : while inflation dropped to 34.7%, the rate of economic growth climbed up to 8% in 1989. The success of this reform turned a new page of Vietnam's history : good performance and stability.

### **2.3 The period 1990-1995**

Vietnam's performance in this period was good. The expectation of inflation was deterred. Trade liberalisation and capital inflows helped to ease the balance of payment problems and budget deficits. In addition, prudent fiscal and monetary policies were used. As figure 2 shows the budget deficit narrowed because of various government attempts. The government increasingly used the non-inflationary sources of financing: outstanding government securities increased to 1.2% of GDP in 1995 from 0.1% in 1988. The monetary financing of the budget deficit was gradually reduced and ultimately halted since 1993.

Although the overall outlook in this period seemed excellent, there were some issues that made the demand management of inflation increasingly harder. While exports mainly concentrated on primary commodities, the need for imports was rising. The country was gradually influenced strongly by the world markets. Likewise, the non-inflationary means of financing and external debts meant that the government expenditures for interest payments were increasing. Tight fiscal and monetary policies would entail larger costs.

Throughout this section, it is argued that the monetary expansion was just passive and accommodating to other factors. Later sections will analyse in more detail these causes and effects of inflation. However, a review of financial development is first made to explain the success of the stabilisation programmes.



Transfers from SOEs in percent of GDP decreased to 7.2% in 1988 from 10.1% in 1986, much smaller than the government SOE subsidies to them (Vo Dai Luoc, 1992: 56). Though inefficient, SOEs contributed chiefly to the government budget revenue due to the agricultural stagnation and discrimination of the private sector. This explained a decreasing trend of budget revenue, from 14% of GDP in 1986 down to 11.3% in 1987-1988, which was likely not sufficient to maintain a healthy macroeconomic stability.

As a poor developing country and with the small private sector, Vietnam had to make numerous investments in capital formation for production (capital expenditures accounted for 45% of total revenues). Faced with inefficiency, the authorities had to expend larger funds for investment to generate the same output. In addition to this, tremendous subsidies (up to 47% of total revenue or 5.3% of GDP in 1988) and large defence/security expenditures, made budget balance really hard to attain. If budget revenue covered 81% of expenses in 1984, in 1985 they covered only 55% (Mc Carty, 1994: 2). Unfortunately, the budget did not directly receive much support from foreign aid, as Soviet assistance took the form of important deliveries of material for enterprises (Ljunggran, 1993: 210). Financial sector and foreign exchange constraints led to money creation, causing a spiralling inflation, showing a peak of 487% in 1986. High inflation intensified budget deficits and induced the speculative demand for inputs and commodities. As the allocator of inputs, the government suffered all costs caused by inflation.

In the 1989 comprehensive reform package, government spending was trimmed off: cessation of most subsidies to SOEs, harder budget constraints, etc. Government spending continued to decrease until 1991. Subsidies to SOEs were removed, resulting in dramatic lays-off. Public sector employment dropped from over four million in 1988 to less than three million (IMF, 1996: 12). In addition, over 500,000 people were released from army service. The austerity was further supported by the oil windfall : oil revenue increased from 1.1% GDP in 1989 to 2% in 1990. The 1988 agrarian reform, the trade liberalisation and the industrial recovery raised government revenues dramatically in most of the later years. Hence, the deficits dropped to 3.7% of GDP in 1990 from 8.0% in the previous year. The eminent danger of three-digit inflation was removed when the rate of inflation reached only 67.5% in that year.

Budget deficits reduced to 1.5%, but economic growth remained sluggish at 5-6% in 1991-1992. To increase the government revenue, a tax reform was introduced, which pushed revenue up to 22.5% of GDP in 1993 from 19% in 1992. The need to have an adequate capital formation and to improve the standard of living, however, widened the budget deficits. Budget deficits rose nearly double from 1993 onward, climbing up to 6% of GDP. However, diversification of non-inflationary financing sources reduced the deficit impacts on the money supply growth. While there were no T-bills in 1986, these securities financed two-third of the deficits in 1992, or even 94% in 1994. All these measures helped to reduce inflation in the years to come. Inflation was only 12.7% in 1995.

In line with economic development, the need for increasing capital formation would soon be evident. After reduction of 2.8% of GDP in 1991, the capital expenditures rose to 5-7% of GDP in the subsequent years. Also pressures on current expenditure were more intense. After the wage freeze in 1989



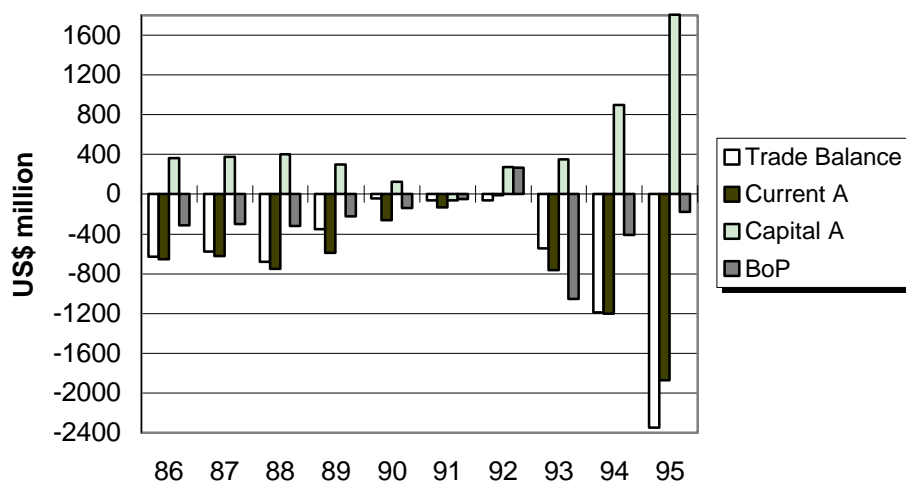
and 1992 stabilisation, the government wage policy should reinforce its management strength. Besides, outlays for social services increased dramatically from 4.4% of GDP in 1991 to 8.2% in 1995. As these items were necessary for development, the government could not reduce its spending in the long run without adverse affects. Economic reforms, oil windfalls and good performance remedied partly the chronic deficit problems. However, the constraints causing budget deficits remained important. Lack of a sound legal framework, corruption, and the outdated tax-collection system made the increasing revenue target harmful to development.

Focusing on the financial sector constraints in Vietnam, this section aimed to confirm the causality between these constraints and inflation in Vietnam. With inefficiency, the political power of SOEs, the infancy of the financial system and sanctions from the capitalist world, the government had no other choice but an extensive money creation. This Vietnamese economic system entailed the unresponsiveness between supply and demand and caused supply bottlenecks. In the transition, attempts to narrow the gap led to budget deficits and then money creation. The accommodation of monetary policy will be highlighted in the next section.

## 4.2 Foreign exchange constraints

As figure 5 shows, the Vietnamese trade deficit remained throughout the period, particularly severe in 1986-1989 and rising dramatically in 1993-1994. However, the impact of this deficit on inflation in these two periods was different, depending on the availability of convertible foreign exchange.

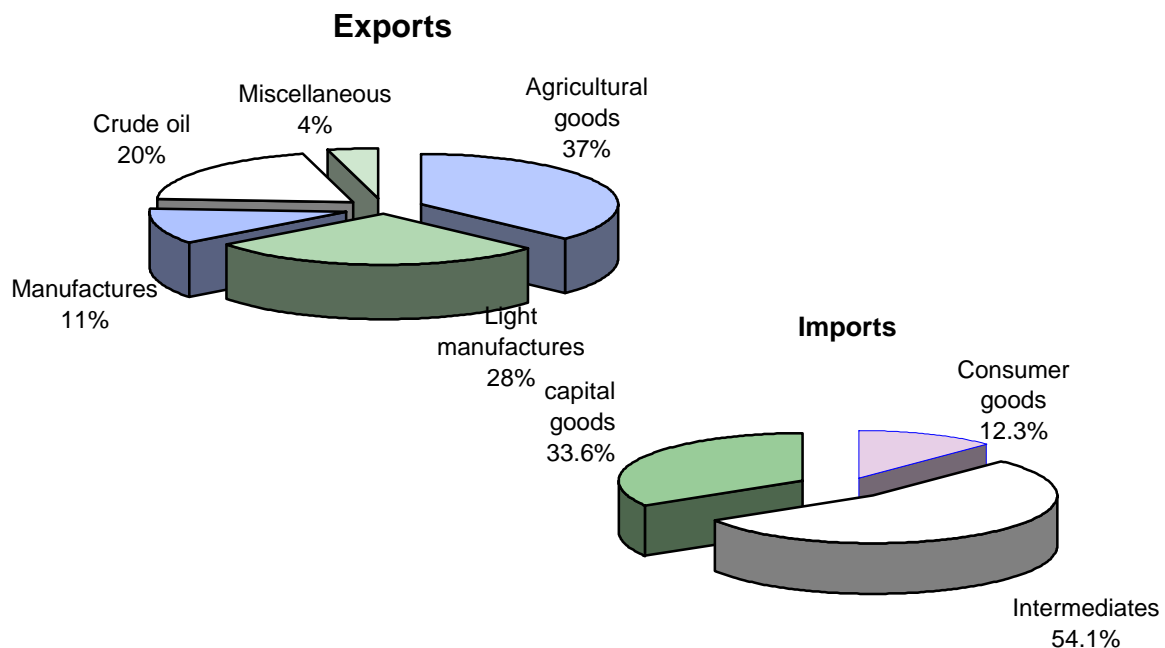
**Figure 5: Balance of Payments, 1986-1995**



Trade deficits and foreign exchange constraints might lead to internal instability if the international assistance did not suffice to finance these imbalances (Struthers, 1981). This in fact, was Vietnam's fate during its transition. Primary exports always represented the largest part of Vietnam's export earnings (Figure 6). Suffering from bad weather conditions and weak world market demand, prices of primary export items fluctuated sharply around a decreasing trend. For instance, the price of exported rice was 225 USD/ton in 1989 then reduced to 187 USD/ton one year later. Likewise, the price of crude oil continuously went down since 1990. The declining trend was even more remarkable in the price of marine products, which dropped by half during 1989-1994. Trade deficit and balance of pay-

ment problems in 1986-1989 were not as severe as in 1993-1995. However, their impacts on inflation were more severe, as the Soviet ruble was not a convertible currency and Vietnam suffered from the US embargo. Shortage of convertible foreign exchange and the limited access to external borrowings led to production inefficiency and thus intensified the budget deficits and financing problems. The passive monetary policy then aggravated the inflationary pressure. Ultimately, the inflation soared tremendously. In 1989-1995, effects of economic reforms, DFI, and credit resumption by international financial institutions pushed up the surplus in capital account. The increase in foreign reserves helped to ease the control of inflation. Capital inflows dampened the impacts of foreign exchange constraints in the short run.

**Figure 6: Share of Goods in Imports and Exports, 1995**



Source : WB, 1996, Vietnam Fiscal Decentralisation and Delivery of Rural Services

### 4.3 Food producing sector

Before the agrarian reform, mismanagement, transportation bottlenecks and poor marketing gave rise to the rigidity in agriculture supply. Shortage of food aggravated the expected inflation. In turn, high inflation eroded the nominal rice contract prices to 10% of the market prices, thus discouraging the agricultural production.

The 1988 agrarian reform received a drastic response from agriculture. Food grains per capita reached 332 kg in 1989 from 266 kg in 1980. From importing food, the country turned into the third largest rice exporter by 1989. Quick supply responsiveness plus the elimination of speculative demand for goods dampened the inflation and resulted in an amazingly high growth rate in 1989. Decline in staples prices diluted the inflation pressure until the middle of 1993, entailing a lower level of aggregate

inflation. In 1994-1995, higher demand for rice export and calamities in the North resulted in a steep increase in staples prices. The staples index rose by 42.6%, pushing the CPI up to 12.7% from 5.3% in 1993.

In brief, supply factors are affecting inflation level in Vietnam. In the presence of shocks, e.g. calamities or a sudden increase in demand from foreign markets, changes in food prices might foster inflationary pressure. This was also confirmed by the IMF study on determinants to inflation in 1994-1995 (IMF, 1996: 24). The regression results showed that the impact of staples prices on inflation was positive and ranked second, higher than money growth and its lagged effects: every 1% increase in staples prices pushes up inflation with more than 0.2%. In the process of industrialisation and urbanisation, the agricultural surplus was likely to reduce significantly. Facing exogenous shocks, agricultural supply rigidities might stimulate the propagating mechanisms, as the case of Bangladesh and Latin American countries (Page, 1993, Dijkstra, 1996).

#### 4.4 The passive monetary policy

The close relation between monetary growth and inflation in figure 2 was insufficient to support the idea that monetary was the only cause of inflation.

Within the classical socialist framework, a passive role of money in the sphere of firms in bureaucratic public ownership was observed and the monetary authorities could not develop an autonomous monetary policy. Hence, the monetary policy was partly, if not wholly, endogenous. (Kornai, 1992: 147, 547). A similar incidence existed in Vietnam. Soft budget constraints, political bargaining power of SOEs and growth targets required the banking system to undertake quasi-fiscal activities, mostly in the form of cheap credit (World Development Report, 1996: 36). In addition, balance of payments problems and the adverse terms of trade aggravated the need for monetary expansion. Under these circumstances, monetary policy was passive: it accommodated the growth targets and spending caused by internal shocks. Facing the infancy of the financial system, money creation was unavoidable. Money in circulation grew from 48% in 1984 to 111% and 512% in 1985 and 1986 respectively. The monetisation of income in 1985 aggravated hoarding. Hoarding of goods became the most favoured substitute for money. The gap between money demand and supply was widened and added to inflationary pressure. Consequently, inflation jumped up in the consecutive three years 1986-1988.

Improvements in the budget balance and external accounts had a strong impact on monetary growth. In 1985-1989, when budget deficits were high and convertible foreign exchange reserves scarce, the money supply expanded rapidly to finance budget deficits and targeted development plans. In 1990-1995, tax reforms and non-inflationary financing were introduced along with the flood of capital inflows. Budget deficits were about to end, while the capital account was in high surplus. That setting propped for the decline in monetary expansion, and the inflationary pressure as well. When the economy suffered the exogenous supply shocks such as these of 1994-1995, a passive monetary policy was observed. Monetary growth led to an increase in inflation of 12-14% from 5.3% in 1993.

When the economy became more open, dollarisation gradually got its share in economic life. Hence, the deposit rate instrument became less effective.

## 5. The 1989 stabilisation policies

The 1980s witnessed the infancy of the financial system, where the process of intermediation and financial institutions was limited. In 1986-1985, the removal of barriers to repressed demand led to an open inflation and thus entailed high inflation expectations. This behaviour was reflected by the rampant hoarding and speculation in goods. As the financial system was hardly developed, the use of deposit and credit controls was of little debate, like the 1989 stabilisation programme, which indeed comprised a policy mix.

A demand side policy component placed emphasis on the increase in the deposit rate, and a reduction of both money creation and fiscal expenditures. The deposit rate instrument was the key factor to curbing inflation. The effect of this tool was tremendous. Monetary deepening rose sharply to nearly 30% of GDP (Figure 4). Demand side policies were assisted by various supply side policies, including the 1988 agrarian reform, trade liberalisation, devaluation, and attraction of capital inflows. The policy mix resulted in good results. Inflation was reduced ten times while economic growth increased by 8%, the highest growth rate since 1985.

## 6. Impact of inflation on growth

Figure 2 could lead to a misleading suggestion of a seemingly negative relation between growth of output and inflation in 1985-1995. In fact, the acceleration of growth was rooted in various supply side policies, especially the agrarian reform. As Luoc stressed, misguiding development policies for a long time before 1989 resulted in increased growth but also in the acute inflation in 1980s (Vo Dai Luoc, 1992: 59).

The 1989 comprehensive reform dampened inflation, but also entailed a decline in industrial growth to minus 2.6%. However, the adverse effect was secured off by supply side policies. The agrarian reform in 1988 granted farmers land-use rights and autonomy in production. It accelerated agriculture output growth at 3.9% in 1988 and 6.89% in 1989. Likewise, banking reform and trade liberalisation led to a drastic growth of the service sector to 9.2% and 18.3% in 1988-1989 from 5.5% in 1987 (Figure 7). This rise was mainly from the improvement in administration, banking, and tourism. With the excellent performance in agriculture and services, the economic growth increased to 8% in 1989.

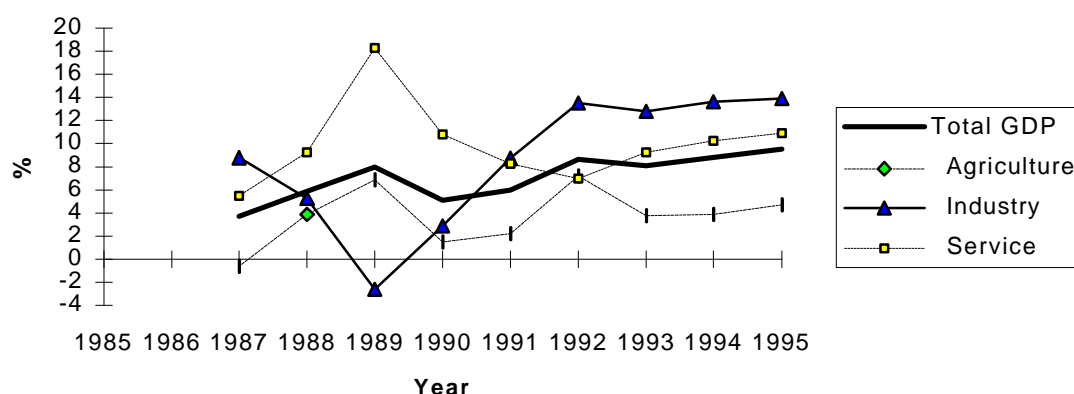
That setting changed since 1990. Agriculture growth slowed down in 1990-1991 in reacting to the decreasing food prices. The service sector grew slower at 8-10% as the effects of 1989 reforms were fading. In contrast, the industrial sector was recovering and growing at 13.4% in 1994 from 2.6% in 1990. Major reasons for this recovery were: the dishoarding of stocks by enterprises and the rise in the utilisation of existing capital stocks in 1990-1991, as reflected in the decline in the ICOR<sup>1</sup>. Second,

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<sup>1</sup> Mc Carty reported a study of Le Dang Doanh that the ICOR of Vietnam was 2.14, 1.56, 1.15, 2.06, and 1.58 during the years from 1988 to 1992 respectively (Mc Carty, 1994).

trade liberalisation allowed capital imports to enhance production. Third, crowding-in effects of DFI. Four, the lifting of private sector discrimination enhanced efficiency. These supply side policies improved the overall efficiency of domestic production and entailed a high growth rate of industrial output as well as in the agricultural sector. In addition, the features of Vietnam's industry also lent a hand to a quick recovery of this sector. Heavy industry was rather small, while the light industry could adjust its production towards demand from the capitalist world. Financial sector constraints deterred the government from bail-out activities to save the SOEs. With these features, the country entered into the transition with less painful costs.

**Figure 7 : GDP Growth by Sector, 1987-1995**



## 7. Conclusions and policy implications

In the 1985-1988 period, the economy suffered an acute inflation in three consecutive years. The year 1989 witnessed a comprehensive reform package. Inflation dropped ten times to 34.7% in 1989 while the growth rate increased to 8%. Acute inflation was prevented in the subsequent period 1990-1995, but it varied substantially. Government intervention was particularly needed to dampen the inflationary pressure in 1994-1995. It helped dilute the adverse impacts of food supply shocks on the whole economy. As a result, the inflation rate remained at 12-14%.

As the monetary policies played an important role in controlling inflation, there were arguments for the continuation of an active monetary policy in the future. Throughout this paper, a “core” theme was to reject this line of argument and that monetary expansion was the direct cause of inflation. Monetary policy was just accommodating to the “real” causes of inflation. Therefore, recognition of the causes entailing the monetary expansion was worthwhile to predict the prospective policies.

The classical socialist model created a dominant inefficient state sector and a rationing system of goods, which failed to generate a sufficiently increasing output and foreign exchange. In addition to the high rate of population growth, prolonged wars and other factors, excess demand thus widened. Facing the infancy of the financial system and the sanctions from the capitalist world before 1989, meeting necessary these expenditures and development targets led to money creation. Acute inflation was seen in 1986-1988.

After the 1989 reform package, supply rigidities were removed. Acceptance of the private sector and trade liberalisation released the supply from the structural bottlenecks. In addition, capital inflows and improvements in the export sector eased the foreign exchange constraints. That setting allowed a non-inflationary financing of budget deficits and thus a decline in monetary expansion. Inflation therefore decreased to a moderate level, at only 12.7% in the end of period. However, structural rigidities did not vanish entirely. As food prices affected strongly inflation, food shocks pushed up the period-to-period inflation up to 19% in 1994-1995, (WB, 1996, Figure 1). In addition, the process of development required enormous spending on infrastructure, public investment and social services. Budget balance was unlikely to be achieved in the medium term unless the outdated tax collection system was revised. On the external accounts, the dependence on primary export and on imported capital goods were hiding trade balance problems. External debt and FDI eased the bottlenecks, but the future debt service and profit repatriation would certainly entail a heavy burden to the BOP. The foreign exchange constraints were thus indispensable to the process of development, though they may be dampened by the continuity of capital inflows.

These factors did not diminish the relevance of the deposit rate instrument and the credit controls in 1989, however. There was a little different theoretical perspective at the point where the financial system was very underdeveloped, expectations of inflation was already built up, and hence the unproductive assets made up a major component of wealth portfolio. A high real deposit rate would stimulate the households to shift their wealth into financial savings. The gap in the monetary market was thus closed and interrupted the inflationary pressure. Under these circumstances, one needed not to worry about the danger of stagflation. The costs of using the deposit rate instrument and credit controls, however, would risen when the financial markets developed and the economy increasingly opened. In this case, the monetary policy would become less effective.

From Vietnam's experience in 1985-1995, the following conclusions can be drawn :

1. The deposit rate instrument and credit controls were most effective when the economy was relatively less open and its financial system was very underdeveloped, in spite of the passive monetary policy.
2. Financial reforms developed the financial system and created non-inflationary means of financing for budget deficit. Money creation would therefore be deterred.
3. Supply side policies were very crucial in the stabilisation programme. These policies helped to offset the adverse impact of the demand sided policies.
4. A favourable international environment helped domestic stabilisation.
5. From the theme of this paper, monetary policies might be useful in some instances. However, they became increasingly less effective as a tool of stabilisation, when the economy was more opened up.

It is necessary to note that stabilisation should be concomitant with the removal of supply rigidities and structural bottlenecks. By doing this, the supply of output was likely to sufficiently increase to offset the disequilibrium in the commodities market. Below are some recommendations to enhance output:

- To increase the volume and diversify the export base.

- To closely manage the imports. Scarce foreign exchange should be used at best in productive activities.
- To enhance the macro-management skills and regulatory systems related to economic activities. Anti-corruption and emphasis on the professional morality of civil workers should be enforced in an effective and determined way.
- Supply shocks may entail shortages in necessities like food. Government intervention via stabilising funds is useful to deter inflation, as was the case in Vietnam in 1994-1995.
- The government should well prepare to accommodate effects of imported inflation.

Policies aimed at a strengthening of supply should not imply that the demand side policies are taken for granted. Prudent fiscal and monetary policies should keep inflation at a level that is not harmful to the economic growth and development. The following policies are recommended :

- The continuity of tax reforms.
- An emphasis on high return investment.
- Prudent monetary policy. Facing exogenous shocks, contractionary monetary policies may deter growth. Stabilisation funds and monetary growth may be necessary to prevent the stagflation.

At present, Vietnam's prospects are good. However, the monetary instruments may not be suited for future stabilisation without generating high costs of slow growth. Instead, more attention should be paid to enhance the capacity, efficiency and competitiveness on the world market. By enhancing the efficiency of production and focusing on productive investment, the constraints will be reduced, leading to a deterrence of inflationary pressures.

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