

Monetary Policy in Vietnam:  
Alternatives to Inflation Targeting

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## List of Acronyms and Abbreviations

ASEAN	Association of South East Asian Nations
BFTV	Bank for Foreign Trade of Vietnam
BIDV	Bank for Investment and Development of Vietnam
CEPT	Common Effective Preferential Tariff
CIEM	Central Institute for Economic Management
CMEA	Council of Mutual Economic Assistance
CPRGS	Comprehensive Poverty Reduction and Growth Strategy
DAF	Development Assistance Fund
FDI	Foreign Direct Investment
FIE	Foreign-Invested Enterprise
GC	General Corporation
GDI	Gender-related Development Index
GDP	Gross Domestic Product
GNP	Gross National Product
GSO	General Statistical Office
HDI	Human Development Index
IMF	International Monetary Fund
JV	Joint Venture
NEER	Nominal Effective Exchange Rate
ODA	Official Development Assistance
PE	Private Enterprise
PER	Public Expenditure Review
PRGF	Poverty Reduction and Growth Facility
PRSC	Poverty Reduction Support Credit
RCC	Rural Credit Cooperative
REER	Real Effective Exchange Rate
ROSCA	Rotating Savings and Credit Associations
SBV	State Bank of Vietnam
SOCB	State-Owned Commercial Bank
SOE	State-Owned Enterprise
UCC	Urban Credit Cooperative
UNDP	United Nations Development Programme
VCP	Vietnam Communist Party
VLSS	Vietnam Living Standards Survey
WTO	World Trade Organization

## 1. Introduction

### *Central Bank Policy: Vietnam Case Study*

One of the most important challenges facing policymakers is to determine how monetary policy should be conducted in order to meet their country's national development goals. In recent years a growing number of central banks have convinced each other that the siren song of inflation targeting (IT) is worth pursuing,<sup>1</sup> even though a strong theoretical case that this monetary rule possesses superior welfare properties has yet to be established. IT calls for the "explicit acknowledgement that low and stable inflation is the overriding goal of monetary policy", which implies that a low inflation target should have supremacy over other development objectives.<sup>2</sup>

For Vietnam, the quest for a pro-development monetary policy has become more urgent because the country is entering a new developmental phase that will be shaped by the terms of its accession to the World Trade Organization (WTO) and commercial treaties with its trading partners. Mindful of both the opportunities and risks that come with this phase, the Vietnamese government has been looking into macroeconomic and monetary policy guidelines to manage this period of unprecedented exposure to erratic swings in the world economy that include commodity price shocks and turbulence in global financial markets. In keeping with recent fashion among central banks, the State Bank of Vietnam (SBV) expressed interest in exploring the feasibility of inflation targeting. However, the general consensus<sup>3</sup> is that at present Vietnam does not meet the necessary conditions to implement an IT regime because the central bank lacks adequate tools to carry out an effective IT monetary policy. Additionally, other policymakers including key players in the ministries of finance, planning and investment, industry and trade do not see the need to adopt strict IT rules and all that it implies (primacy of

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<sup>1</sup> Bernanke and Mishkin, 1997.

<sup>2</sup> However, Mishkin (2000), an advocate of inflation targeting, acknowledges that price stability is "a means to an end, a healthy economy, and should not be treated as an end in itself" and that "central bankers should not be obsessed with inflation control".

<sup>3</sup> This view is shared by proponents of IT who were invited by the SBV to give seminars on the subject.

inflation targeting over all other development objectives), nor are they willing to cede to the SBV that degree of power. There is also the larger question of whether an IT regime is compatible with Vietnam's development priorities, and whether it would help or hinder the restructuring of the economy, to improve economic performance over the long run.

The context for discussing monetary policy in Vietnam is as follows: upon launching sweeping reforms during the 1990s, the country has generally followed the East Asian "developmental state"<sup>4</sup> model. In the view of its political leaders, monetary policy should serve as a tool to meet their country's socio-economic development goals, which are rapid and sustainable growth, modernization, industrialization, and poverty reduction. According to the 1998 Law on the State Bank of Vietnam (SBV), the task of the central bank (SBV) is to stabilize the value of the currency, secure the safety of the banking system, and facilitate socio-economic development in keeping with the nation's socialist orientation (Nguyen Duc Thao 2004, Kovsted et al. 2002). SBV senior officials consider this a mandate to control inflation and promote economic growth (Le Xuan Nghia 2005). The implied assumption shared by policymakers and the public is that the nominal exchange rate and the domestic price level are closely linked. This link became highly visible during the difficult period preceding the *Doi Moi* (Renovation) reforms when Vietnam grappled with hyperinflation and associated large depreciation of the parallel market exchange rate. Unlike many developing countries, Vietnam has a strong domestic constituency for low inflation because of its earlier traumatic experience with hyperinflation, which heightened public sensitivity to price movements. That said, a strong preference for low inflation and willingness to carry out policies to support a low inflation environment does not mean that the central bank has a clear mandate to adopt formal inflation targeting. Furthermore, Singapore has shown that it is possible to target a trade-weighted exchange rate while also stabilizing inflation without having to impose a formal IT regime.

This paper hopes to contribute to the search for the right mix of macroeconomic and monetary policies that can best serve Vietnam in the coming period of greater openness and intensified competition in both domestic and export markets. It focuses on the

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<sup>4</sup> The "mission" of a "developmentalist" state is to promote sustained economic development through steady high rates of economic growth and structural change in the productive system (Castells 1992).

conduct of monetary policy in Vietnam: how it is made, and how it should be made. It examines the factors that should guide monetary policy, taking into account the current state of Vietnam's transition to a more market-oriented economy and the challenges posed by dollarization, financial repression, informal and underdeveloped financial markets, and rapid international economic integration. Not surprisingly, it finds that critical gaps in knowledge, institutional arrangements, tools and rules are impeding the effectiveness of monetary policy.

Believing that the main task of the central bank should be to maintain macroeconomic prices that are conducive to rapid and sustainable economic growth, an alternative to IT is proposed. To support Vietnam's transition to a more market-oriented economy, the central bank should instead target a real exchange rate (RER) that is stable and competitive. The reason is that this key relative price has a more powerful influence on the allocation of labor and capital, and on the composition of domestic output, than administrative levers typically employed by centrally planned economies. Maintained over an extended period, a stable and competitive RER promotes an efficient allocation of resources and employment-creating growth, reinforces macroeconomic and financial stability, and encourages financial market development.

The paper argues that a stable and competitive RER is a superior intermediate target for several reasons. *First*, this target clearly implements the Law on the State Bank of Vietnam (SBV),<sup>5</sup> which states that the SBV's task is to stabilize the value of the currency. Since Vietnam now has multiple important trading partners, the value of the domestic currency should be stabilized against a trade-weighted basket of currencies that take into account differences in their respective rates of inflation. *Second*, it improves the transparency of monetary policy and strengthens confidence in the central bank's ability to conduct monetary policy effectively because the targeted rate of currency exchange is both sustainable and growth enhancing. In other words, the central bank is assigned a task that is realistic and therefore doable. *Third*, a stable and competitive RER can contribute substantially to economic growth and employment creation if it is supported

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<sup>5</sup> Law on the State Bank is dated December 12, 1997.

by complementary fiscal, monetary, and industrial policies<sup>6</sup>. *Fourth*, it can have positive medium- to long-term impacts on structural change and development through a variety of channels: resource allocation, changes in production techniques, growth of capital stock including stock of human capital (Frenkel and Taylor 2005)<sup>7</sup>. *Fifth*, compared to a strict focus on inflation targeting which tends to slow economic growth and lower employment growth (Epstein 2003), a real exchange rate target is more likely to be a more effective stabilizing force and can do a better job in dampening output volatility during periods of global turbulence.

A stable and competitive RER's long-term positive impact<sup>8</sup> on resource allocation and the composition of output takes place through its influence, both direct and indirect, on key macroeconomic prices such as the domestic interest rate, the relative price of traded to non-traded goods, the relative cost of capital and labor, and the import-export price ratio.<sup>9</sup> The real exchange rate, used in conjunction with appropriate commercial and industrial policies<sup>10</sup>, can serve as a development tool in coordination with other monetary policy instruments to strengthen the economy's overall competitiveness, increase aggregate productivity, maintain external balance, contain inflation and stabilize asset markets (Frenkel and Taylor 2005). International evidence from cross-country empirical research provides support for this view: instability (variability) of the RER is found to be negatively related to growth (Montiel 2003, Corbo and Rojas 1995), and overvaluation of the RER (in other words, an uncompetitive RER) has been linked with slower growth (Montiel 2003, Razin and Collins 1997).

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<sup>6</sup> Specifics regarding these complementary fiscal, monetary and industrial policies are necessarily the subject of another paper.

<sup>7</sup> Frenkel and Taylor (2005) emphasize that the real exchange rate must be kept at a stable and competitive level for a relatively long period if the positive effects are to take place. The reason is that responses to the new (competitive) set of relative prices take time because they involve restructuring firms and sectoral labor market behavior. This takes place over time via changes in the pattern of output among firms and sectors, and adjustments in technology and organization of production.

<sup>8</sup> The long-term effects take into account the time lag from when investment decisions are made and productivity gains are realized.

<sup>9</sup> The cost of capital goods and intermediate inputs affects the export/import price ratio.

<sup>10</sup> Such policies may include private-public partnerships to encourage the establishment of effective training facilities to improve labor force skills.

The paper is organized as follows: Section 1.2 provides a brief history of Vietnam's banking system. Section 2 analyzes the macro economy from the perspective of identifying transmission mechanisms. Section 3 examines the issues surrounding the framework for monetary policy. Section 4 describes the merits of a stable and competitive real exchange rate as a superior alternative to IT.

### ***Vietnam's Banking System: Brief History***

From 1976 to 1989, like other centrally-planned economies, Vietnam's single-tier banking system was owned and controlled by the state. The SBV provided nearly all domestic banking services through a vast branch network. Bank lending was state directed, and credit rationing was imposed because financial resources were scarce. Trade and infrastructure finance were managed by two specialized banks. The Bank for Foreign Trade of Vietnam (BFTV), established in 1963, had a monopoly over the financing of foreign trade and foreign exchange transactions. The Bank for Investment and Development of Vietnam (BIDV), established in 1958, handled the financing of public works, infrastructure projects, and equipment for SOEs (World Bank 1991).

During this period, SBV offices served as the interface between state planning, the national budget, and state entities including some 12,000 state-owned enterprises (SOEs)<sup>11</sup>. The SBV's task was to ensure that financial resources were allocated to economic units in accordance with the plan. Under central planning, the SBV was not required to carry out many traditional functions of commercial banking such as credit analysis or risk management. Domestic and international payment systems functioned poorly, and payment by check between provinces would often take from two to six

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<sup>11</sup> In 1989, the SOE sector was made up of about 12,000 enterprises, of which 3100 were in industry; while the remaining were in trade, construction, agriculture and services. Most SOEs were provincial or district enterprises that were managed by the Industrial Bureaus of the provincial or district People's Committees (World Bank 1991). The reform of state enterprises, a key component of the *Doi Moi* reforms, subject the SOEs to a hard budget constraint. A massive restructuring of the state enterprise sector took place. By 1992 the number of SOEs fell by nearly half to 6,545 enterprises, and their labor force was cut from 2.7 million to 1.7 million (IMF 1998).

months<sup>12</sup>. As a result, many enterprises ignored the check payment system and instead used couriers to make direct cash payments (World Bank 1991).

The quantity of currency outside banks was very high (the ratio of currency outside banks to nominal GDP reached 9.2 percent in 1986) as the government attempted to monetize sharply rising fiscal deficits as revenue growth failed to keep pace with rising expenditures<sup>13</sup>. SOEs in Vietnam lacked fiscal discipline as they operated under the soft budget constraint that was common among socialist countries. To circumvent credit rationing, they engaged in unauthorized credit creation through various means such as abuse of the check payment system (see footnote 3) and use of supplier credits<sup>14</sup> as a substitute for borrowing in credit markets. These practices had inflationary consequences, created financial problems for the SBV, and contributed to a deterioration in the consolidated balance sheets of SOEs, because the accumulation of ‘accounts payable’ debits in the balance sheets of debtor SOEs was mirrored in ‘accounts receivable’ credits in the balance sheets of creditor SOEs.

Before money and capital markets were established during the 1990s, household liquid and semi-liquid assets mainly consisted of the domestic currency, gold, hard currency notes, and easily tradeable commodities such as rice. Remittances from overseas Vietnamese<sup>15</sup> contributed to the dollarization of the economy and growth of the domestic

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<sup>12</sup> Initially the SOEs were allowed to make payments to third parties by issuing checks drawn on their accounts, but many abused the system by generating unauthorized overdrafts. Moreover, they used their political influence to avoid sanctions. In response, the SBV restricted not only the use of checks drawn by the SOEs on their own accounts, but also of bank drafts or cashier’s checks for interprovincial payments. Banks were prohibited from opening correspondent accounts with banks in other provinces. All interprovincial interbank transactions had to be conducted through the SBV. In other words, the SBV effectively replaced the check payment system by a more cumbersome arrangement involving multiple SBV branches at various stages in the payment. This slowed down the money transfer process, and payment delays of between two and six months became common (World Bank 1991).

<sup>13</sup> The expenditures included the costs of maintaining a large military force, direct subsidies to SOEs, and indirect subsidies associated with price controls.

<sup>14</sup> This is done by delaying or failing to repay credit extended by their suppliers which generally were other SOEs. The Vietnamese term employed by SOE managers to describe this practice is *chiem von nhau* (conquering each other’s working capital).

<sup>15</sup> This usually took place through informal channels due to unfavorable regulations governing formal money transfers. Recipients were forced to take the money in Vietnamese currency at an exchange rate which effectively gave them half or sometimes only a third of the amount they could get in the open market (Beresford and Dang Phong 2000).

stock of hard currency notes (which was and still is mainly denominated in US dollars). Throughout the 1980s, to protect the value of their assets during periods of inflation volatility and hyperinflation, households attempted to draw down their domestic currency holdings and replace them with gold, rice and US dollar assets. This drove up the black market price of gold and US dollars<sup>16</sup>. Continued efforts by households and other economic agents to protect themselves from inflation by getting rid of their domestic currency holdings (causing the ratio of currency outside banks to nominal GDP to decline from 9.2 percent in 1986 to 6.6 percent in 1988) only worsened the inflationary spiral.

The 1987-89 macroeconomic and fiscal crisis<sup>17</sup> and hyperinflation provided the impetus for the comprehensive and coordinated *Doi Moi* reforms that included reforms in public finance and in Vietnam's banking and financial sector. In 1988 the Prime Minister signed Decree No. 53/ND which ended the monobank system and created a two-tier system consisting of the SBV as the central bank and four state-owned commercial banks (SOCBs). In addition to the BFTV and BIDV, two new SOCBs were created out of two SBV departments. The Industrial and Commercial Bank of Vietnam (ICBV) was created out of SBV's industrial and commercial loan department, and the Agricultural Bank of Vietnam (ABV) was created from the agricultural credit department. In addition, the government ended BFTV's monopoly on financing foreign trade and BIDV's monopoly on providing long-term finance. The intent was to increase management autonomy and responsibility, and to introduce the pressure of competition in order to improve bank performance (World Bank 1991).

In 1990, the government promulgated two banking ordinances for a two-tier banking system. These ordinances transformed the SBV into a central bank with oversight over the domestic banking system and provided the legal framework for commercial banks and other financial institutions. The government liberalized entry into the banking system and lifted rules on sectoral specialization of the SOCBs. Commercial banks were given

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<sup>16</sup> According to the General Statistics Office (GSO), in 1981 the market exchange rate was four times the official rate; in 1985 it was 11 times the official rate (Tran Van Tho et al. 2000).

<sup>17</sup> External shocks such as the collapse of trade with the CMEA and the end of external financing by the former USSR contributed to the macroeconomic crisis.

responsibility for the operation and control of their finances and implementation of universal banking activities.

Without the banking reforms, the government's other structural reforms and stabilization measures would have been less effective. The combined effect of unification and massive devaluation of the exchange rate<sup>18</sup>, legalization of gold trading, domestic price liberalization, sharp increases in deposit interest rates, imposition of a hard budget constraint on most SOEs (see footnote 2), and curtailment of credit growth, all acted together to lower inflation expectations and induced major adjustments in the composition of household liquid assets.

The decision to raise the interest rate for household deposits in the formal banking system increased confidence in the domestic currency and encouraged households to deposit their dong assets in bank accounts (see Figure 1). In 1989, real interest rates on household deposits rose sharply, and encouraged a steady rise in the value of household deposits at the SOCBs, from VND 207 billion in March 1989 to VND 1,348 billion by January 1990 (see Figure 2). Other indications that the reforms gave rise to a significant portfolio adjustment of household liquid assets included the sharp drop in the free market prices of gold and US dollars (by about 20 to 25 percent) in the spring of 1989 (World Bank 1992, Dollar 1993), as households reduced their gold and US dollar holdings. This massive portfolio adjustment helps to explain why the sharp rise in M2 as a share of nominal GDP (from 16.7 percent in 1988 to 30.5 percent in 1989) -- and more modest rise in domestic currency outside banks as a share of nominal GDP (from 6.6 percent in 1988 to 8.4 percent in 1989) -- coincided with a big drop in the annual inflation rate (from nearly 350 percent in 1988 to only 36 percent in 1989). This contrasted with the 1986 period when a similar ratio of domestic currency outside banks as a share of nominal GDP signaled that inflation was out of control, and suggests that historical and economic context should guide our interpretation of key monetary ratios.

As regards the current conduct of monetary policy, the National Assembly and the government both play a role. Similar to the U.S.—whose constitution gives its national legislative body, the U.S. Congress, formal and practical authority over its central bank,

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<sup>18</sup> The official VND/USD exchange rate went from 375 VND per USD in 1988 to 4635 VND per USD in 1989, which all but eliminated the gap with the parallel market rate.

the U.S. Federal Reserve—and in contrast to the Czech Republic, Hungary, Slovakia and Slovenia (Camen 2006), the Vietnamese central bank does not have exclusive responsibility to design an independent monetary policy<sup>19</sup>. Unlike countries that have adopted inflation targeting policies, the SBV has limited operational independence.

The broad division of labor is as follows: the government's task is to prepare a plan for monetary policy that includes an inflation forecast, while the National Assembly's tasks are to set an annual target for the inflation rate that is consistent with the state budget and economic growth objectives, and to supervise the implementation of monetary policy. As it now stands, Vietnam's monetary policy strategy is but a component of the broader five-year socio-economic development strategy that is formulated by the government and the ruling Communist Party. Within this framework, the SBV's role is to come up with a concrete action plan for the banking sector, which includes setting targets for the amount of liquidity needed by the economy. Specifically, the SBV announces annual targets for total liquidity (M2 growth) and credit growth (Camen 2006). However, the goal of keeping within credit growth targets does not appear to receive high priority as actual credit growth in both 2004 and 2005 were well above the targeted growth rate of 25%.

Similar to India and China, Vietnam uses a mix of market-based instruments and changes in reserve requirements to carry out monetary policy. The SBV would like to reduce its reliance on direct instruments, preferring to use indirect instruments. However, given the current level of financial market development and weaknesses in the monetary transmission mechanism, Vietnamese monetary authorities have no qualms about employing direct instruments to get the job done.

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<sup>19</sup> Testifying before the U.S. House Committee on Financial Services, at the June 17, 2007 hearings on the conduct of monetary policy under the Humphrey-Hawkins Full Employment and Balanced Growth Act, Professor James Galbraith of the University of Texas at Austin summarized the legal basis for the conduct of U.S. monetary policy as follows: "These hearings [under the Humphrey-Hawkins Act] remind us that, unlike some central banks, the Federal Reserve is not wholly independent. It is a 'creature of Congress,' subject to oversight and to economic goals and objectives specified by law. Congress wisely grants to the Federal Reserve broad discretion in the conduct of monetary policy. But these hearings provide a forum whereby that conduct may be reviewed, questioned, criticized, and held to account. ... As its title suggests, the Full Employment and Balanced Growth Act set into law goals for the economic policy of the United States, including for the Federal Reserve. Those goals included full employment and reasonable price stability - a precise statement of what is now often called the 'dual mandate.'"

The SBV is also tasked with stabilizing the exchange rate<sup>20</sup>, an appropriately vague mandate that ought to direct the authorities to maintain a trade-weighted inflation-adjusted exchange rate that promotes sustainable (non-inflationary) growth over the medium to long term. Following a period of significant appreciation of the real effective exchange rate (REER) that lasted until mid 2002, which created difficulties for Vietnamese exporters, the REER has been steadily depreciating, reflecting Vietnam's faster rate of inflation rate relative to that of its main trading partners. From January 2000 to December 2006, Vietnam's real effective exchange rate has depreciated measurably, especially in comparison to China and its Southeast Asian neighbors (see Figure 3A). This depreciation corresponds to a moderate acceleration of Vietnam's GDP growth rate from 6.8% in 2000 to 8.4% in 2005, and a somewhat more rapid acceleration of the inflation rate (see Figure 3B). This looks to be a sustainable level for the real exchange rate and the SBV ought to try to keep the REER at this level for an extended period to ascertain that this set of relative prices indeed creates a favorable growth environment for Vietnamese enterprises. Like China and Singapore, the Vietnamese currency is officially pegged to a basket of currencies, and like China, the authorities do not disclose the currency composition in the basket nor the basket weights.

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<sup>20</sup> SBV intervention in the foreign exchange market to support the targeted rate of exchange takes the form of buying and selling foreign currency or engaging in foreign exchange swaps.

## **2. Description of the Macro Economy**

### ***2.1 GDP and Macro Aggregates: Mechanisms of Adjustment***

#### **2.1.1 Incomplete Information, Informal Financial Markets and Structural Change**

To carry out monetary policy effectively, policymakers in Vietnam need to have a much better grasp of the actual mechanisms of transmission and adjustment than they do at present. For example, the transmission of monetary policy via the interest rate channel is unclear because credit market segmentation, financial repression, and credit rationing add additional layers of murkiness to the process. Through its short-term policy rate and commercial bank reserve requirement, the SBV is able to influence the commercial bank lending rate and activity levels of enterprises that borrow from the formal financial sector. However, its influence over credit growth in the informal financial sector and informal lending rates is not at all clear<sup>21</sup>.

Unlike their counterparts in single-currency countries, Vietnamese central bankers operate under rather extreme conditions of incomplete information. They are unable to obtain an accurate picture of the relationship between the money market and the real economy because key variables needed for IS-LM type analysis are missing. The picture also is obscured by the country's ongoing structural transformation that has led to a gradual flattening of the IS curve, as investment spending becomes more sensitive to interest rate changes. This is illustrated in Figure 3, where the expected link between gross capital formation by enterprises and real lending rates does not emerge until after 1994. Even so, investment spending in Vietnam continues to be less sensitive to interest rate movements compared to other countries with more developed financial sectors. This is because retained earnings continue to be the main source of financing for business capital spending.

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<sup>21</sup> The explanation for this is as follows: as in other countries where credit market segmentation play an important role, firms in Vietnam that have access to the formal banking system become key actors in the process of credit creation. They act as financial intermediaries to credit-constrained firms by providing the latter with trade credit. In other words, institutional factors help to turn interfirm credit into an imperfect substitute for bank credit.

To elaborate further on the problem of incomplete information, both aggregate money supply and important elements of the money demand function are unknown (Hauskrecht and Nguyen 2004) because the economy is partially dollarized and there is no reliable data about the quantity of US dollars and stock of gold outside the banking system that are used as a medium of exchange and a store of value<sup>22</sup>. This complicates interpretation of the observed link between money and prices, and explains the confusing empirical findings from VAR-type analysis undertaken by government research institutes. Consider the Quantity Theory of Money (QTOM) identity

$$MV=PQ$$

where the pass-through from money (M) to prices (P) is straightforward if velocity (V) is a fairly constant trend variable. However, in Vietnam aggregate “true” M is hard to estimate because it includes M2 (recorded by the SBV), foreign deposits held in banks, as well as two significant unobserved variables: private sector foreign currency holdings and gold in circulation. It is also likely that the domestic and foreign currency will have different velocities (Hauskrecht and Nguyen 2004) with different trajectories.

Figure 4 presents the velocity time path for currency outside banks (V1) and for total liquidity M2 (V2), which includes currency outside banks, domestic currency deposits and foreign currency deposits. Two mutually offsetting influences on velocity deserve mention. Ongoing structural reform of the financial sector and improvements in the payments system increases velocity. At the same time, in a multi-currency economy a large-scale portfolio switch to the domestic currency can lower velocity. Figure 4 illustrates this: from 1991 to 1994, households and firms switched to the domestic currency and reduced their non-bank foreign currency and gold holdings as they trusted more the government’s ability to control inflation. This brought about a decline in velocity and also led to greater monetary deepening.

Accurate tracking of domestic credit growth also is critical to the effective conduct of monetary policy. This is yet another problem for the central bank, because key variables

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<sup>22</sup> Both function as “a quasi second legal tender” or “parallel currency” in the economy (Hauskrecht and Nguyen 2004). The government can track the quantity of currency outside banks and the quantity of dong and dollar deposits. However, the quantity of gold and hard currency held by households and other economic agents that are used as a medium of exchange and store of wealth is not known.

that affect financial sector development and domestic credit growth in Vietnam are difficult to estimate. These include the magnitude of interfirm credit as a percent of aggregate credit creation, and the quality of their accounts receivable (which may pose a significant risk to the banking system). Consequently, the SBV is largely in the dark as it attempts to manage aggregate liquidity, and is dependent on a limited set of indicators to figure out if it is on the right track. Complicating its task is the murky link between bank credit growth, the inflation rate, and actual borrowing by business enterprises (see Figure 3) due to the coexistence of formal and informal financial markets, and the role of interfirm credit.

### 2.1.2 Transmission Channels: A Very Cloudy Picture

In this section we examine three main channels of monetary policy transmission: via exchange rates, interest rates, and credit aggregates.

As regards exchange rates, the impact of the central bank's exchange rate policy<sup>23</sup> on the real economy is difficult to determine because we do not know how Vietnam's informally pegged exchange rate regime affects the growth of monetary aggregates. The SBV does not provide information on its interventions in the foreign exchange market<sup>24</sup> and there is no explicit sterilization policy. An examination of the detrended growth path<sup>25</sup> of net foreign assets, net domestic assets, and M2 suggests that the authorities may have engaged in some sterilization, but there is no clear pattern that would suggest a systematic effort to sterilize. However, it is generally believed that at times these interventions have been substantial (Camen 2006). Thus far, SBV actions to manage the informal peg do not appear to have negative consequences. The M2 growth rate has not been overly volatile and the inflation rate has been low. As shown in Figure 5, the VN

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<sup>23</sup> The SBV's policy has been to maintain a stable relationship vis-à-vis the U.S. dollar, while permitting a gradual depreciation in an effort to balance the need for export competitiveness with the need to reassure domestic currency holders of the Vietnamese dong's integrity as a store of value. It intervenes in the foreign exchange market through foreign exchange swaps or by buying and selling foreign currency.

<sup>24</sup> For this reason, it is difficult to determine whether there is upward or downward pressure on the domestic currency.

<sup>25</sup> Quarterly data, not seasonally adjusted.

dong's relationship to the US dollar has been fairly stable, no negative pressure on the stock of international reserves was detected, and financial deepening expanded rapidly from 1999 on, which indicates growing confidence in the domestic currency.

Using monthly data from 1992 to 1999, a CIEM (government research institute) study employed VAR models with error correction terms to study the relationship between money, prices, and output (Vo Tri Thanh et al. 2001). The actual variables used were currency outside banks, M1, M2, the consumer price index (CPI), the interbank exchange rate, and industrial output in real terms. The study found that changes in monetary aggregates had no predictive power as regards the future movement of inflation or output growth (this is not surprising, for reasons explained in Section 2.1.1). Instead, the results from the VAR models suggest that money growth responded to past movements in inflation and output, indicating that the money supply was passive (endogenous) during that period. A very interesting (though not surprising) finding, which holds important policy implications for the SBV, is that – in contrast to changes in monetary aggregates – the interbank exchange rate contained significant advance information on the evolution of output. For this reason, the SBV should conduct empirical research to determine how the exchange rate can serve as a transmission channel for monetary policy.

The evolution of net foreign assets as a percent of total liquidity<sup>26</sup> and the annual growth rate of credit to the economy<sup>27</sup> is presented in Figure 6 (measured on right axis), while the left axis tracks the inflation rate and real GDP growth rate. Careful inspection of the path of credit growth and GDP growth suggests that a high rate of credit growth tended to precede an acceleration of the GDP growth rate, but surprisingly, there is no discernible relationship between credit growth and the inflation rate. The interactions between financial and real variables are further obscured because the estimate of credit growth presented in Figure 6 only captures loans extended by the formal banking sector and the trajectory of credit growth in the informal financial sector is not known.

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<sup>26</sup> Total liquidity is M2, defined as the sum of net foreign assets and net domestic assets.

<sup>27</sup> The authors of the CIEM study noted that monthly observations of credit growth were not available to include in the VAR models.

The breakdown of liquidity growth is presented in Figure 7. It shows that both net foreign assets and net domestic assets have been rising rapidly. The main contributors to rising foreign assets are worker remittances, remittances from overseas Vietnamese<sup>28</sup> (which eventually show up in the form of hard currency reserves held by commercial banks), foreign direct investment (FDI), and ODA. These four categories of foreign financial inflows are influenced in various ways by government policies and regulations (including those issued by the SBV) and have strong effects on the real economy.

## ***2.2 Employment and structure of labor markets***

Vietnam's segmented labor market mainly consists of the agricultural/rural sector, the informal urban sector, and the formal urban sector. The degree of mobility between these sectors is in part socially and institutionally determined, and in part determined by policy-induced patterns of structural change in the economy and associated shifts in relative prices such as changes in the real exchange rate. For this reason, labor market segmentation can be eased by monetary policy strategies that are supportive of structural change. Since 1998, the formal sector in Vietnam has been expanding rapidly due to policy reforms and rapid economic growth. This is seen in the rapidly rising share of the working age population in nonfarm wage employment, especially from 1998 to 2002. During this period this share nearly doubled from 11.8 percent to 22.3 percent (Table 1 and Figure 8), thanks to depreciation of the real exchange rate which had the effect of increasing profitability in the tradeable goods sector.

The share of wage-earners in the rural workforce hardly changed from 1993 to 1998, but nearly tripled from 1998 to 2002, indicating that a very rapid transformation of the rural economy was taking place. It should be noted, however, that the share of wage earners in the rural workforce remains quite low at 15.2 percent. During the period of

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<sup>28</sup> Remittances are sent by ethnic Vietnamese living abroad and by Vietnamese migrant workers whose foreign stay is largely temporary. The number of migrant workers has increased because the government adopted policies to promote labor exports. It is estimated that about 50,000 workers were sent overseas to work in 2001 and worker remittances is estimated to exceed USD 1.25 billion, making labor one of Vietnam's key exports.

rapid growth of the formal labor market, from 1998 to 2002, households belonging to the middle three expenditure quintiles experienced sharp increases in nonfarm wage employment, a sign of improved labor mobility. Most of the Vietnamese labor force are still in the low productivity agricultural/rural sector. Rural household income tends to be low, erratic and unstable due to the seasonal pattern of farm employment and volatile swings in world agricultural commodity prices. The rural workforce, which mainly consists of household enterprises, self-employed and unpaid family workers, is in a state of flux with rural-urban migration playing an important role. The movement of labor out of the agricultural/rural sector began to accelerate after 1998 when the real exchange rate depreciated, so the share of labor in agriculture has started to shrink.

### **3 Macroeconomics and institutional frameworks of central banking**

#### ***3.1 Issues surrounding scope for inflation targeting***

Although there is interest in inflation targeting (IT) on the part of the SBV, and a steady stream of international experts came to Vietnam to conduct seminars on IT for SBV senior management<sup>29</sup>, the consensus view is that at present, the conditions to support a formal IT monetary framework are not met. The reasons are evident (see Sections 1 and 2) when we consider the four main conditions outlined by the IMF that are deemed necessary to support such a framework (Carare et al. 2002):

- The central bank has a clear mandate to make IT the primary objective of monetary policy and is publicly accountable for meeting this objective.
- The inflation target will not be subordinated to other objectives and monetary policy will not be dominated by fiscal priorities.
- The financial system is developed and stable enough to implement the IT framework.
- The central bank has adequate policy instruments to be able to influence inflation.

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<sup>29</sup> They include Hans Genberg and Edwin Truman.

At present, the SBV has limited scope to implement monetary policy using market-based indirect instruments to influence inflation<sup>30</sup>, although this has long been its declared objective, because financial markets are thin and not well developed (the government securities market is segmented and illiquid). In addition, as explained in Sections 1.1 and 2.1, the government is only at the early stage of building the necessary foundations (including timely access to a high frequency databank of key economic and financial variables needed for policy analysis) for developing a “reasonable understanding of the links between the stance of policy and inflation”.

As for making IT the primary objective of monetary policy, the government is not likely to wholly buy into this notion. While Vietnam does have inflation targets, it does not have a strict IT regime and the inflation target does not have priority over other development objectives such as rapid and sustainable growth. Under the 1998 Law on the State Bank of Vietnam (SBV), the National Assembly sets the inflation target, and it is the task of the SBV (and other government agencies) to meet this target. However, Vietnamese political leaders are unlikely to sacrifice growth or employment objectives to meet the inflation target, even though they believe that controlling inflation is necessary for growth to be sustainable. Indeed, their country’s experience over the past 20 years has taught them that the stability of key macro prices (inflation rate, exchange rate, and interest rates) helped to support the very high economic growth rate that was achieved.

Nevertheless, this appreciation of the need to keep inflation in check does not win them over to the view that inflation targeting should trump all other development goals, especially if there is a risk that efforts to meet the targeted inflation rate could result in economic contraction. In this matter, they are right. Even if the conditions to support a formal IT framework were met, a rigid IT monetary policy would probably get in the way of meeting the country’s national development objectives. This is because an IT regime

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<sup>30</sup> As regards indirect monetary policy instruments, during the mid-1990s the SBV introduced and has been using required reserves, refinancing and discount lending facilities, open market operations and foreign exchange interventions. The refinancing rate and the discount rate together define the upper and lower band for the open market operations rate although on occasion this rate does move outside the band (Camen 2006). Actual money policy implementation in Vietnam is similar to that in China. The People’s Bank of China’s primary instruments are open market operations, interest rate policy (including interest rates on central bank lending and other rates including banks’ base deposit and lending rates) and reserve requirements.

imposes strict rules that tie the hands of policymakers, preventing them from responding in more appropriate ways to external exogenous shocks.

There are many reasons why a rigid IT framework is not appropriate for Vietnam, even if the conditions for IT are met. First, it gives primacy to the wrong target (inflation), forcing policymakers to operate in a framework that implicitly accords higher priority to inflation than to other more pressing development objectives. For example, it obliges the central bank to automatically adopt a tightening stance whenever the inflation indicator rises above its target range, or risk being branded as incompetent for failing to stick to the inflation target. A rigid IT framework also sets false standards for judging the quality of monetary policy, distracting policymakers from more serious and arduous efforts to understand the actual workings of their economy, so as to identify effective instruments to influence economic activity.

Second, it is not so easy to determine what should be the right rate of inflation to target, and the SBV may find it much too tempting to simply follow the lead of other central banks even when it may not suit Vietnam's particular circumstances. Indeed, advocates of a particular inflation target should be required to show how that targeted rate would support the country's primary development objectives. In addition, the specific inflation indicator to target is not readily obvious. Should it be the consumer price index, the private consumption deflator, or a broader measure of asset inflation? Furthermore, how should the central bank respond if these different measures of inflation were to send conflicting signals, as has already occurred in many instances?

Third, it sends the wrong message about what is needed to ensure good policymaking. The implicit underlying justification for IT is that policymakers cannot be trusted to make sound policy decisions. The assumption is that they tend to give in to short-sighted political demands that can harm national social welfare over the long run. Therefore, to protect against this, policymakers must be bound to tight rules and explicit objectives, and they must be held publicly accountable to meeting these objectives. Although there are good reasons to mistrust policymakers, tying their hands with rigid rules and wrong targets could very well push the economy onto a different path that departs sharply from the country's development goals.

An instructive contrast is Singapore's monetary policy, which has centered on management of the exchange rate since 1981. Philosophically it is the opposite of IT's "tie their hands" approach. Defying conventional wisdom, Singapore's exchange rate regime is a managed float: the Singapore dollar (SGD) is managed against a basket of currencies of its major trading partners and competitors. To give itself full flexibility, the Monetary Authority of Singapore (MAS) does not reveal the composition and weights of this basket except to say that it is revised periodically to take into account changes in the country's trade patterns. According to MAS, the SGD is allowed to fluctuate within an undisclosed policy band to provide "some buffer in the estimation of the country's equilibrium exchange rate, which cannot be known precisely" (MAS 2001), and to accommodate to short-term fluctuations in foreign exchange markets. Another way in which MAS gives itself ample room to maneuver is to affirm that "the exchange rate policy band is periodically reviewed to ensure that it remains consistent with the underlying fundamentals of the economy" and "to avoid a misalignment in the currency value" (MAS 2001). Put differently, MAS allows the trade-weighted exchange rate to appreciate or depreciate – as it sees fit – to take into account different phases of the international business cycle, domestic productivity growth, and the domestic savings rate.

It is important to note that flexibility should not be confused with lack of discipline. MAS rejected adoption of a floating exchange rate regime because it feared that a freely floating SGD could exhibit excessive volatility or even worse, "become misaligned over a sustained period of time, leading to resource misallocation" (MAS 2001). It also rejected adoption of a fixed exchange rate regime, believing that its credibility was already well established thanks to prudent fiscal policies, a long track record of low inflation, and sufficiently large reserves to defend the exchange rate against currency speculators. To adopt a nominal anchor is tantamount to adopting the anchor country's monetary policy, MAS argues. This may impose a heavy cost during periods when the business cycles of the two countries diverge. The experience of Hong Kong is illustrative: during the early 1990s Hong Kong's currency peg to the U.S. dollar meant that it had to adopt the U.S. monetary policy, which was then loose, when a tighter stance would have been more appropriate. This led to an unwanted asset price bubble, with painful consequences.

MAS also believes that pegging either to a single anchor currency or to a trade-weighted basket would make it more difficult for their small open-economy to absorb shocks from abroad, or adjust the value of the exchange rate to be consistent with Singapore's underlying macroeconomic fundamentals (MAS 2001). During the Asian financial crisis, if the SGD had been pegged to a trade-weighted currency basket, MAS would have had its hands tied and been forced to depreciate significantly against the USD, undermining confidence in the SGD at a time when market sentiment was weak. Its experience during the Asian financial crisis led MAS to conclude that its 'managed float' exchange rate policy provided the government with the needed flexibility to cope with periods of unprecedented turbulence in foreign exchange markets and uncertain economic conditions.

Proof of the resounding success of Singapore's monetary policy is in the pudding, as it were – the island economy is renowned for the rapid rise in domestic per capita income in real terms and ability to maintain over many decades a remarkably high economic growth rate despite numerous external shocks. At the same time, the average domestic rate of inflation is below 2 percent and mean-reverting (in other words, the authorities are able to return the inflation rate its long term average rate following large shocks such as the 1997-98 Asia financial crisis).

### ***3.2 Quality of Monetary policy***

Surprisingly, the government managed to achieve excellent macroeconomic results in spite of having to operate somewhat in the dark (given the critical gaps in information described in some detail in Section 2.1.1) with the crudest of monetary tools to influence aggregate demand. One explanation for this success is that these constraints did not prevent the government from pursuing the right fiscal and monetary policies (see Section 1.2). The authorities knew what needed to be done to strengthen confidence in the domestic currency, and summoned the willpower to take disciplined action. They established credibility through deeds, not words, by maintaining macroeconomic stability and keeping inflation under control over a prolonged period, from 1990 to 2005. The gains from achieving this credibility can be seen in the progress made in monetary

deepening, as the ratio of M2 to nominal GDP more than doubled from its nadir in 1993. The reintermediation of foreign currency previously held outside the banking system also indicates greater confidence in the banking system. According to the IMF (2002) foreign currency deposits almost doubled to USD 3.1 billion.

Thus far, policymaking credibility has remained strong – despite poor information and weak monetary instruments – because key fiscal and monetary policies have been well managed. Both the stock and flow of government debt (including debt denominated in foreign currency) have stayed at prudent levels, the outlook for fiscal balance remains healthy, and the expected trajectory for the current account deficit does not give cause for concern. A benign situation will continue as long as the government is able to maintain enough space to maneuver. However, the monetary authorities do not have adequate tools at present to protect the economy from exogenous shocks, which means that Vietnam’s vulnerability to external shocks will increase as its economy becomes more integrated with the global economy.

Moreover, the risk of policy error is likely to increase if the government fails to address the issue of critical gaps in information. As noted in Section 2.1.1, the coexistence of formal and informal financial markets and the role of interfirm credit in liquidity creation have made the relationship between bank credit growth and actual borrowing by business enterprises not so straightforward. Without better information, the central bank runs the risk of misinterpreting data and may respond inappropriately, with dire consequences. For example, the SBV may attribute a “too high” rate of credit growth to excessive monetary or fiscal easing, when in fact these high numbers may actually be the result of credit reallocation due to a secular rise in the formalization of credit and decline in informal sector lending.

## 4 Investigating Alternatives to Inflation Targeting

### 4.1 *The Real Exchange Rate is a Better Target*

An alternative policy target should be consistent with and support Vietnam's national priorities. In other words, an important criteria for the target is that it should play a positive development role and actively support the economy's structural transformation. To this end, we need to specify the critical components of this economic transformation in order to sharpen monetary policy's role, and to ensure that it becomes a coherent part of the nation's development strategy.

Taking into account these considerations, a stable and competitive real exchange rate (SCRER) is a better intermediate target because it helps to advance Vietnam's national priorities, which are rapid and sustainable growth, modernization, industrialization, and poverty reduction. In contrast to IT regimes that have been found to push many economies into a lower employment growth trajectory, SCRER targeting would contribute to growth and employment creation through its impact on resource allocation, rewarding firms that adopt forward-looking production technologies and encouraging them to develop promising new businesses. Moreover, a monetary regime that is committed to maintaining a SCRER enhances policymaking credibility because the central bank is assigned a realistic and achievable task since a SCRER target is both sustainable and growth enhancing. Singapore's successful experience with its managed float regime (discussed in Section 3.1) suggests that it is within the realm of possibility.

To lay the foundations for sustainable growth, strategies that give priority to developing the medium-to-large (MLE) enterprise sector may be more effective than strategies that advocate concentrating resources on developing the small-to-medium enterprise (SME) sector.<sup>31</sup> This is because mid-size enterprises have better capacity for learning and for technological innovation, and can create more jobs faster. Development of this sector will accelerate formalization of the economy (enabling policymakers to better monitor economic activity), promote human capital development, technological

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<sup>3131</sup> I am indebted to Philippe Scholtes at UNIDO for calling my attention to this issue.

development, development of management skills, and strengthen the competitiveness of domestic firms. The scarcity of MLEs in Vietnam has impeded financial sector development — essential for balanced economic growth — because the banking system is missing an important class of borrowers.

Although much hope has been placed on the small-to-medium enterprise (SME) sector as the primary employment-creating engine, it is unlikely that this sector would be able to create the quantity and quality of jobs needed to absorb Vietnam's growing labor force. This pessimistic view of the job-creating role of the SME sector is supported by findings from a recent survey of industrial enterprises conducted by the General Statistical Office (GSO). At present 95 percent of registered industrial enterprises fall in the small-to-medium (SME) category, which is defined as having less than VND 10 billion in registered capital and employing fewer than 300 regular workers. According to UNIDO (2004), although they represent 95 percent of all enterprises, they account for only 34 percent of total enterprise employment. As indicated in Figure 10, half of all registered industrial enterprises (50 percent of the smallest SMEs) create only about 5 percent of total employment, absorb 3 percent of total capital, and generate about 1 percent of total profits<sup>32</sup>. What this means, as UNIDO (2004) has pointed out, is that a marginal unit of capital invested in small enterprises will generate considerably less profit than if it were invested in larger companies. Given that the long term survival and growth of enterprises depends on their being able to maintain a healthy profit rate, the stability of employment growth in the formal sector is closely linked to an environment that is conducive to MLE growth. Important aspects of this environment are monetary policies that send consistent signals to affirm the basic stability of key macroeconomic relative prices including the real exchange rate. This is needed so that enterprises will be confident enough to carry out their investment plans in order to develop in areas that are most likely to be profitable.

A SCRER targeting framework for monetary policy is key to promoting rapid expansion of the MLE sector. This is necessary to ensure that employment in the formal sector (which is dependent on MLE growth) will increase at a rate that can absorb

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<sup>32</sup> The graph on the right of Figure 6 show that 80 percent of all registered industrial enterprises employ between 5 and 50 regular workers.

Vietnam's rapidly growing labor force (about 1.2 million new entrants to the workforce every year). The economic well-being of Vietnamese workers depend on this, because wage rates in the formal sector are significantly higher than informal sector wage rates. A SCRER target also helps the government to reduce its reliance on administrative levers to bring about desired changes in the economy. Officials have less justification to yield to pressure from firms in import-substitution sectors for special protections. If firms in sectors such as paper, steel and cement are unable to survive and prosper in a favorable price environment created by a SCRER, the government should conclude that they are unlikely to achieve long term commercial viability. Consequently, the economy would achieve better resource allocation if these firms were to close down their operations.

#### ***4.2 Conclusion***

In this paper, I have argued that a strict inflation targeting regime is not appropriate for Vietnam. IT's rigid rules constrain policymakers to operate in a framework that requires inflation to take priority over more pressing development objectives. As previously noted, Vietnam is in the process of becoming more integrated with a world economy that is increasingly prone to uncertainty. Policymakers urgently need to respond flexibly to changing global conditions with discipline and with intelligence. For this reason, it is unwise to embrace an inflexible monetary policy framework that ties their hands. Rather, they need to explore alternative strategies that may be even more effective in maintaining stable prices, while also providing a favorable environment for a pro-development structural transformation of the economy. I argue that a stable and competitive real exchange rate is that superior alternative, precisely because it sets as a target a key macroeconomic relative price that is realistic, sustainable, and growth enhancing.

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