Toward a more robust monetary policy framework in Vietnam

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Motivation

- With structural reforms, Vietnam can march toward emerging market status

- Reforms should focus on creating institutions that deliver strong fundamentals and enhance economic resiliency

- The SBV can contribute to this endeavor by

  - Increasing policy predictability

  - Delivering low and stable inflation

  - Supporting demand management to maintain growth at full potential

Motivation

- Vietnam's monetary policymakers are facing multiple challenges:

    - Conflicting policy objectives

    - No operational autonomy

    - Monetary policy effectiveness (impaired banking sector)

    - Low international reserves

- How can these challenges be met?

Key messages: A desirable monetary policy framework

- Simplify monetary policy mandate by putting low and stable inflation as primary objective

- "Managed floating" with increasing flexibility (wider trading band) over time

- Phase out administrative controls

- Clear monetary policy communication

- Aim to transition toward explicit inflation anchor at distant future

Outline

1. **Characterizing current framework**

2. **Evidence of monetary policy effectiveness**

3. **Policy challenges**

3. **Framework that can meet the challenges**

Current framework

Current framework: Policy objectives

- SBV Law states the objective as: "*stabilizing currency value expressed by inflation target.*"

- But SBV is guided by multiple policies:
  - Promoting economic growth
  - Containing inflation
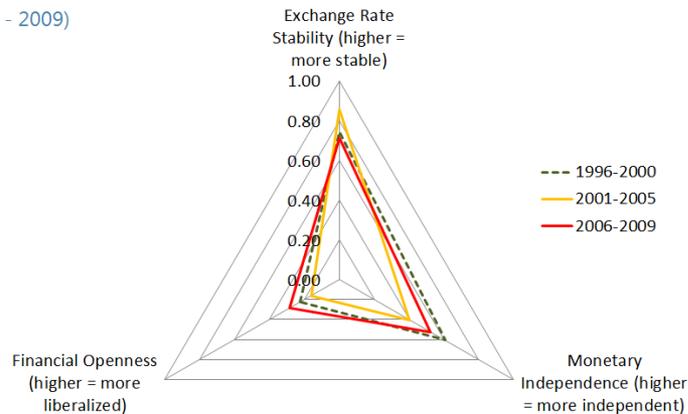 - Preserving financial stability
  - Exchange rate stability

INTERMEDIATE FX REGIME, RELATIVELY CLOSED FINANCIALLY

... LIKE OTHER FRONTIER ASIA ECONOMIES, ON AVERAGE
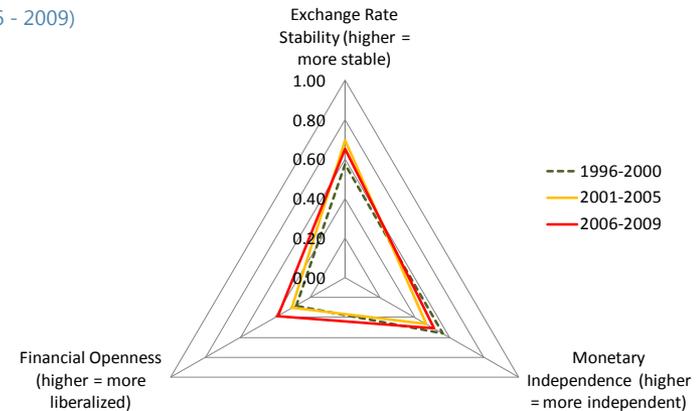
Vietnam: Trilemma Index
(1996 - 2009)

Sources: Updated database based on Aizenman, Chinn, and Ito (2008)
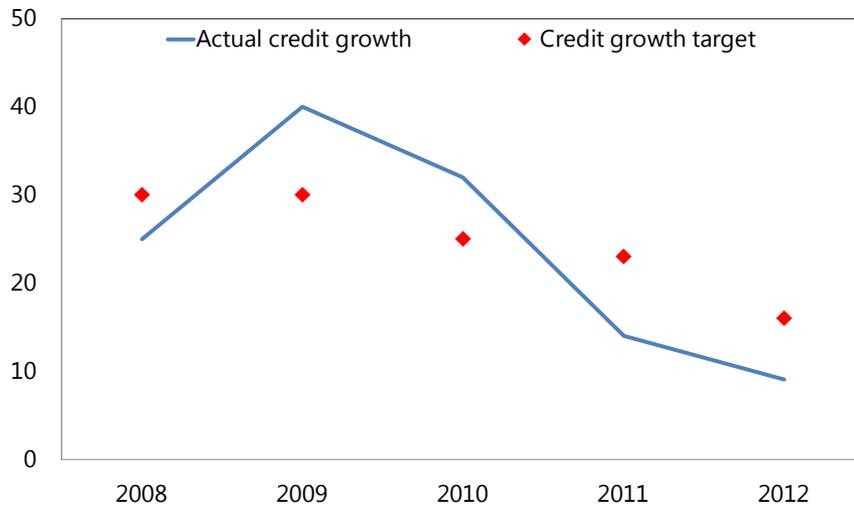
FD Asia: Trilemma Index
(1996 - 2009)

Sources: Updated database based on Aizenman, Chinn, and Ito (2008)

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Current framework: A mixed regime

WITH MONETARY TARGETING FLAVOR...

... AND ELEMENTS OF EXCHANGE RATE TARGETING

Vietnam: Credit Growth and Target
(In percent)

Source: SBV

Vietnam: Exchange Rates[1]
(Dong per U.S. dollar)
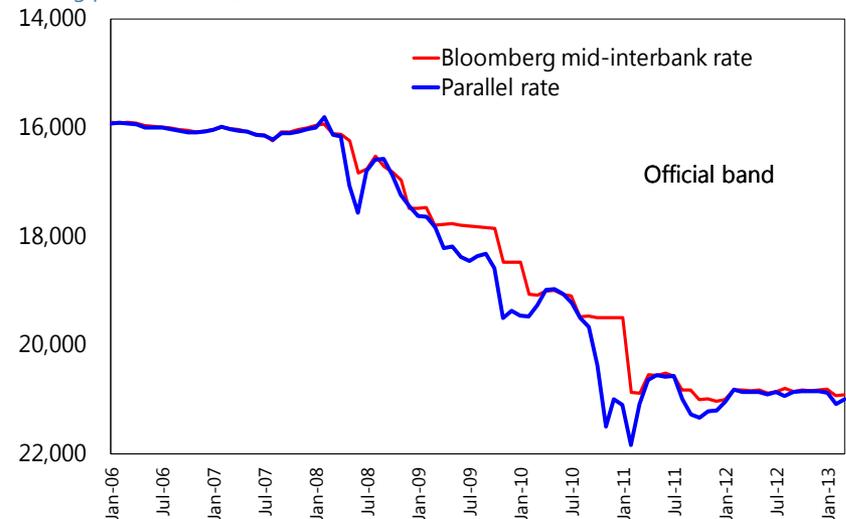
Sources: Vietnamese authorities; and Bloomberg L.P.
1/ An upward movement indicates an appreciation.

Current framework: Multiple instruments

INTEREST RATES

DIFFERENTIATED TIERS OF RESERVE REQUIREMENTS

Vietnam: Policy Rates

(In percent)

Source: Vietnamese authorities

(in percent)	Deposits in Dong		Deposits in foreign currencies	
	< 12 months	> 12 months	< 12 months	> 12 months
SOCBs; Urban, Foreign, Joint Venture Banks; Financial and Leasing companies	3	1	8	6
Agricultural/Rural Development, Rural/Cooperative Banks, Central People Credit Fund	1	1	7	5
Social Policy Bank, Local People Credit Funds, CIs with deposits of < VND 500 mn	0	0	0	0
CIs abroad	0	0	1	1

Source: SBV

Current framework: Administrative control (examples)

- Deposit rate caps in VND and USD.
  - VND deposits of more than 12 months are liberalized (Circular 19/2012)

- Lending rate caps to priority sectors
  - Agriculture, exports, SMEs and supporting industries, and high-technology business

Current framework: Communication

- **Exchange rate stability**

  - "**Manage flexibly the exchange rate** and [FX] market following market supply and demand, BOP developments and other [macro] balances"

- **Monetary policy stance**

  - "**Manage flexibly** and simultaneously **monetary policy instruments**; **reserve money** in line with **M2** and credit to obtain monetary policy objectives; control **credit growth** to about 12 percent in 2013"

Current framework: Communication

- **Interest rate adjustment** (follow **inflation signal**, **bank liquidity**, and maintain **macroeconomic stability**)

  - "… continue to apply the **deposit caps** to stabilize the market interest rate"

- **Recent interest rate decision** (March 25)

  - "… owing to **inflation slowdown. … corporate sector** still facing difficulties from weak demand … and **slow loan demand**"

Policy Effectiveness: Evidence

Inflation process determination

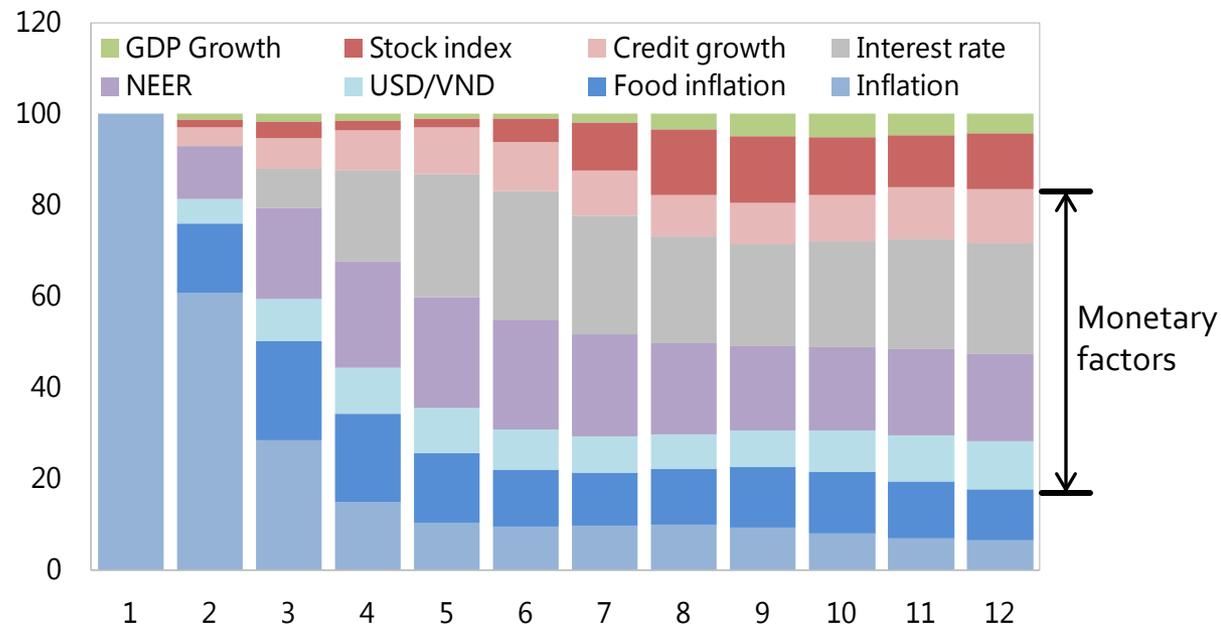## A MONETARY VAR

- *Headline inflation* is *not persistent*. It is influenced largely by *monetary factors* and *food prices* after 3 quarters' horizon

VARIANCE DECOMPOSITION

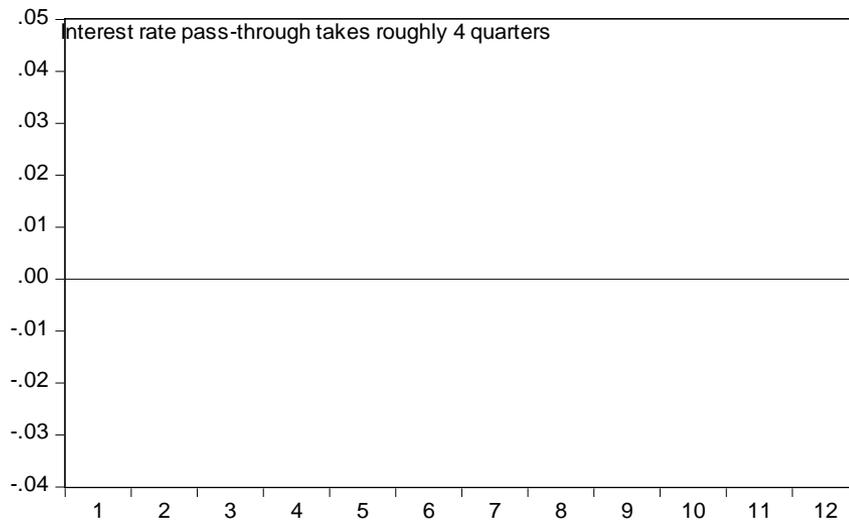**Variance Decomposition of Inflation Process**
(In percent)

Legend: GDP Growth, Stock index, Credit growth, Interest rate, NEER, USD/VND, Food inflation, Inflation

Monetary factors

Sources: Vietnamese authorities; IMF's WEO database; Bloomberg L.P.

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Policy transmission to inflation

INTEREST RATE TRANSMISSION SEEMS WEAK

EXCHANGE RATE IS MORE EFFECTIVE

Response of Inflation to Cholesky
One S.D. Interest Rate Innovation

Response of Inflation to Cholesky
One S.D. NEER Innovation

Interest rate pass-through takes roughly 4 quarters

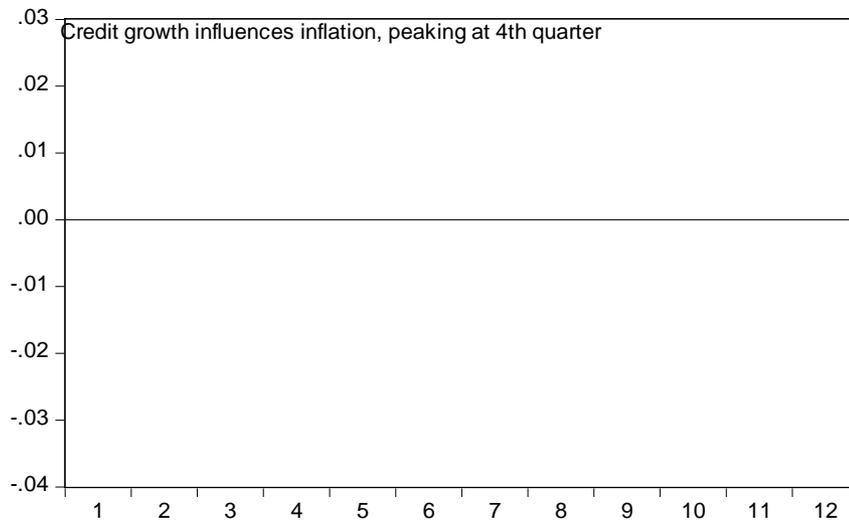Exchange rate pass-through is quicker, significant, peaking at quarters 4-5
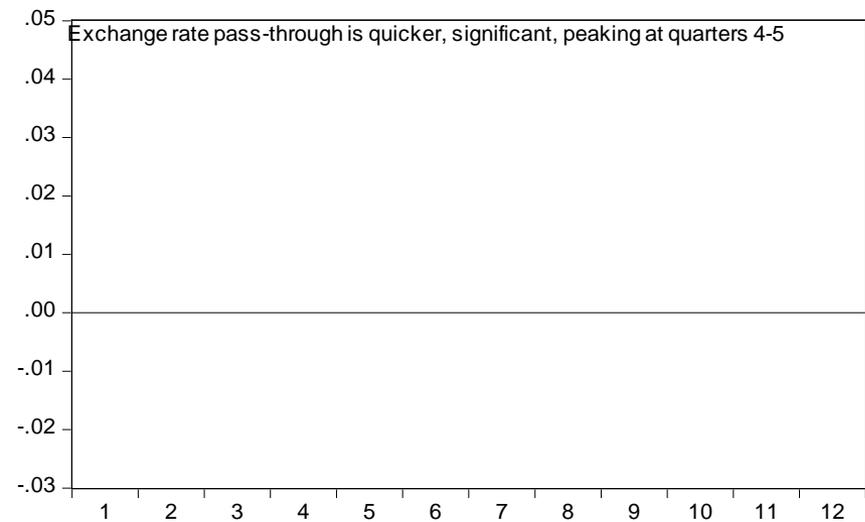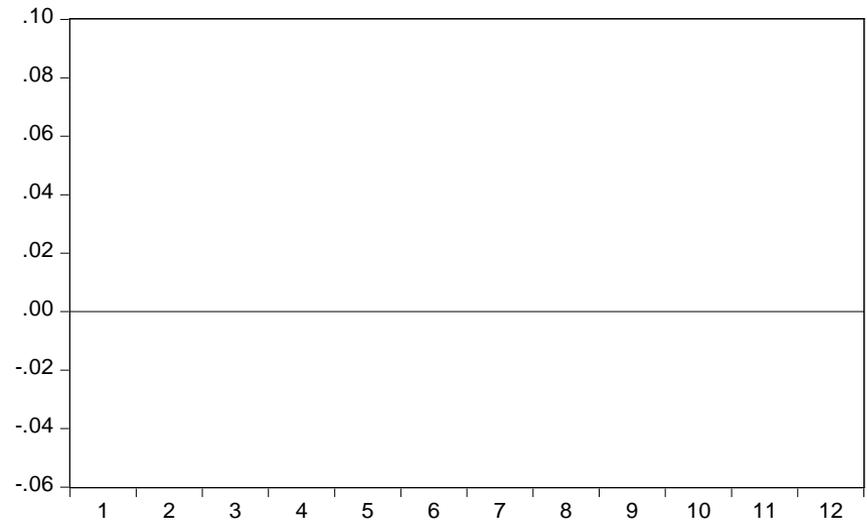
Policy transmission to inflation

ON AVERAGE, THE CREDIT CHANNEL HAS WORKED...

... BUT INDEPENDENTLY OF INTEREST RATES

Response of Inflation to Cholesky
One S.D. Credit Growth Innovation

Response of Credit Growth to Cholesky
One S.D. Policy Interest Rate Innovation
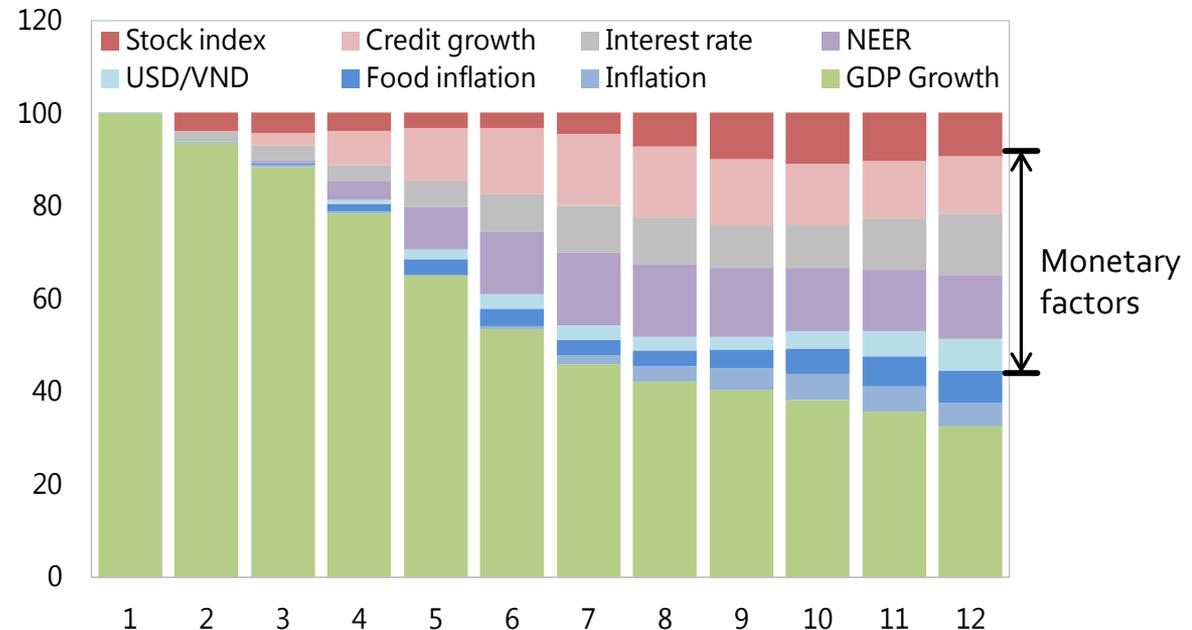
Growth process determination

A MONETARY VAR

- **Growth is persistent.** It is influenced *mostly* by non-monetary factors during the first 6 quarters

VARIANCE DECOMPOSITION

Variance Decomposition of GDP Growth Process
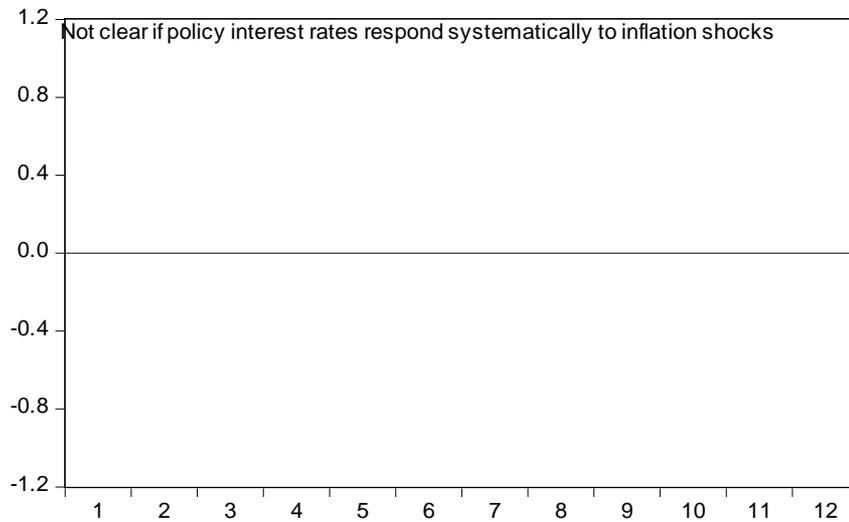(In percent)

Sources: Vietnamese authorities; IMF's WEO database; Bloomberg L.P.

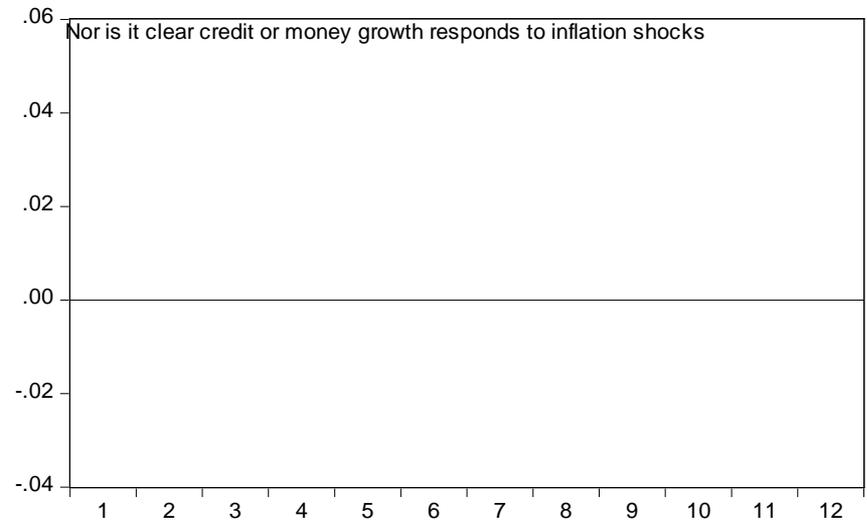# Does policy react to rising inflation?

INTEREST RATE INCREASES?   CREDIT GROWTH SLOWS?

Response of Interest Rates to Cholesky
One S.D. Inflation Innovation

Response of Credit Growth to Cholesky
One S.D. Inflation Innovation

Not clear if policy interest rates respond systematically to inflation shocks

Nor is it clear credit or money growth responds to inflation shocks

Does policy react to positive growth shock?

## "COUNTERCYCLICAL" INTEREST RATE POLICY?

Response of Interest Rates to Cholesky One S.D. GDP Growth Innovation

Unclear if policy interest rates act in a counter-cyclical manner systematically
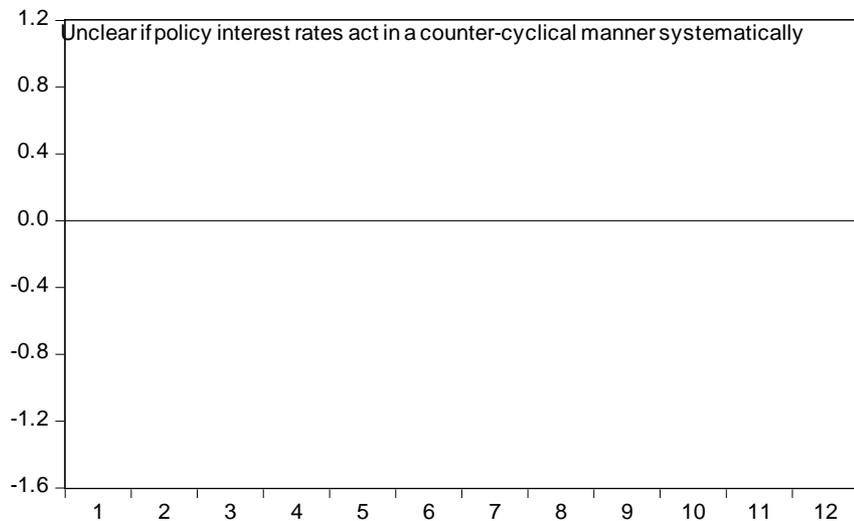
"PROCYCLICAL" CREDIT GROWTH POLICY?

Response of Credit Growth to Cholesky One S.D. GDP Growth Innovation

Credit growth restraint seems to be implemented after 1 year, with initial procyclicality
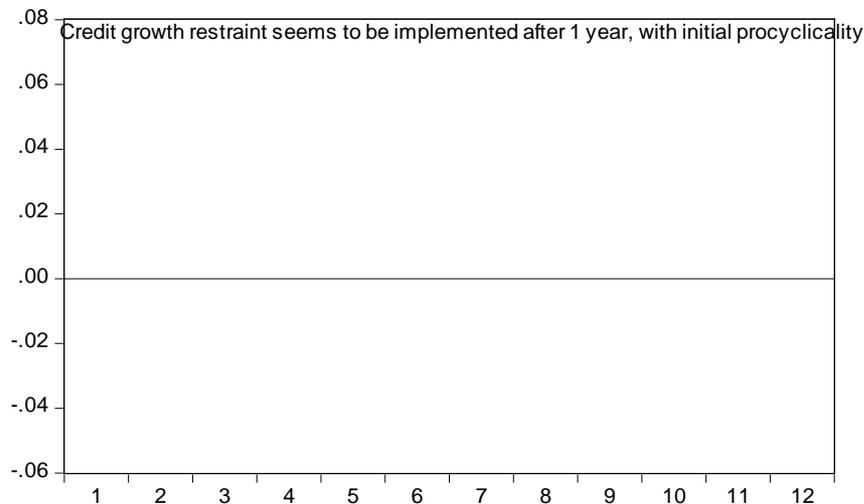
Excessive credit growth points to significant "growth bias"

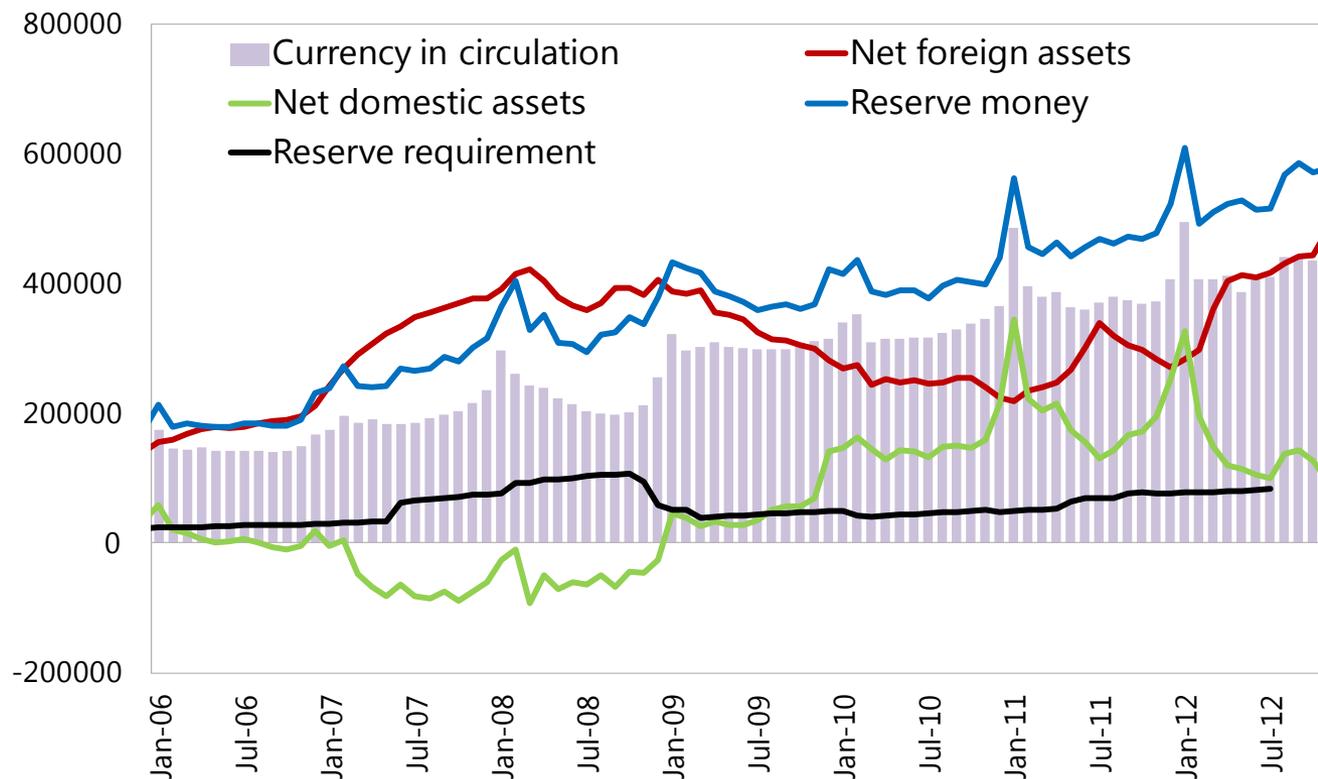**Vietnam: Credit to GDP Gap[1]**
(In percent)
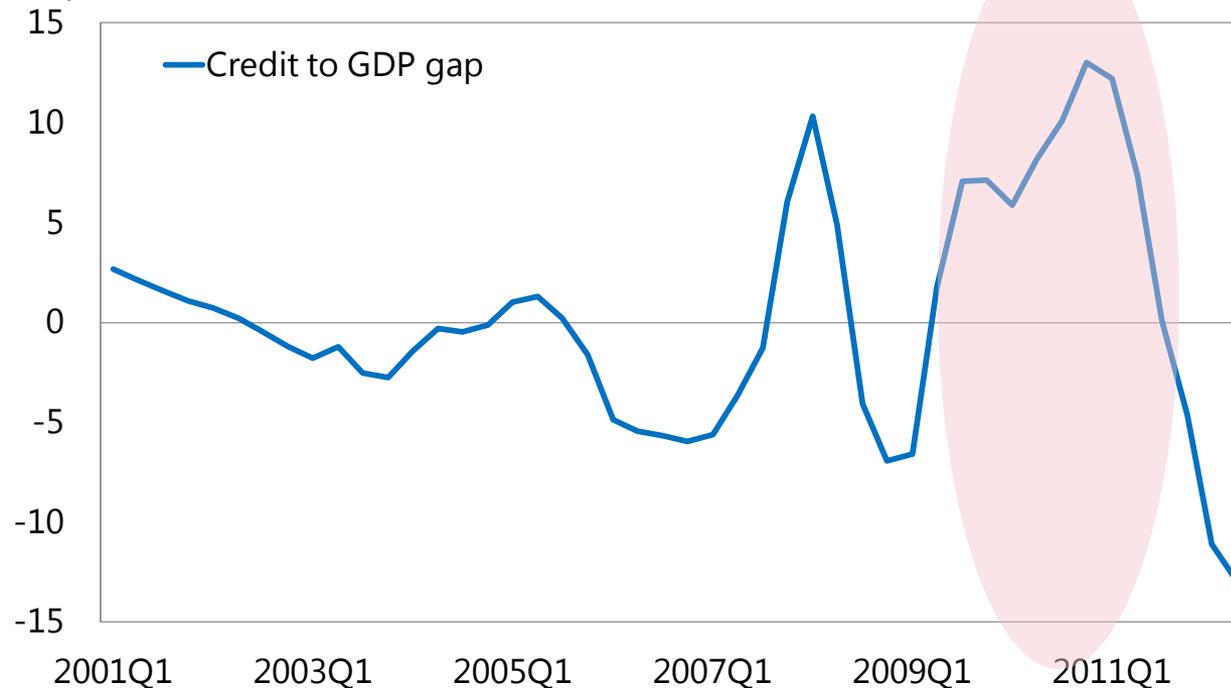
Source: IMF staff estimates
1/ Gap estimates derived using a Hordick-Prescott filter.

… also reflected in monetary base management

Vietnam: Management of Monetary Base
(In billions of dong)

Source: Vietnamese authorities

Lessons from empirical analysis

- ## Clarify monetary policy targets
  - Monetary policy (interest and exchange rates) can influence inflation
  - … while near-term growth is influenced more by non-monetary factors
  - Support demand only when inflation is checked

- ## With impaired credit channel, rely more on the market-based instruments
  - In near term, use interest rates to support exchange rate anchor
  - Phase out administrative controls
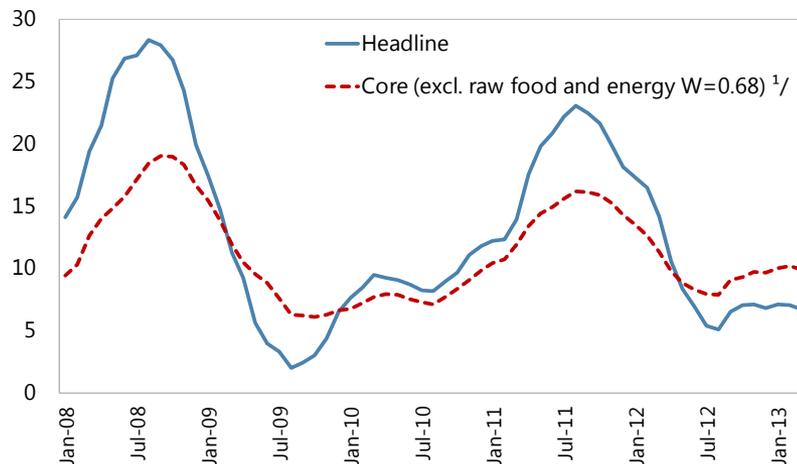
Policy challenges

Challenge 1: Contain inflation, and REER appreciation pace

HIGH AND PERSISTENT UNDERLYING INFLATION ...

... RAISES COSTS OF DOING BUSINESS

Vietnam: Inflation
(Year-on-year percent change)

Legend: Headline; Core (excl. raw food and energy W=0.68) [1]

Source: Vietnamese authorities
1/ W=2009 Weight

Real Effective Exchange Rates [1]
(Index, January 2006=100)

Legend: Vietnam; ASEAN-4; China
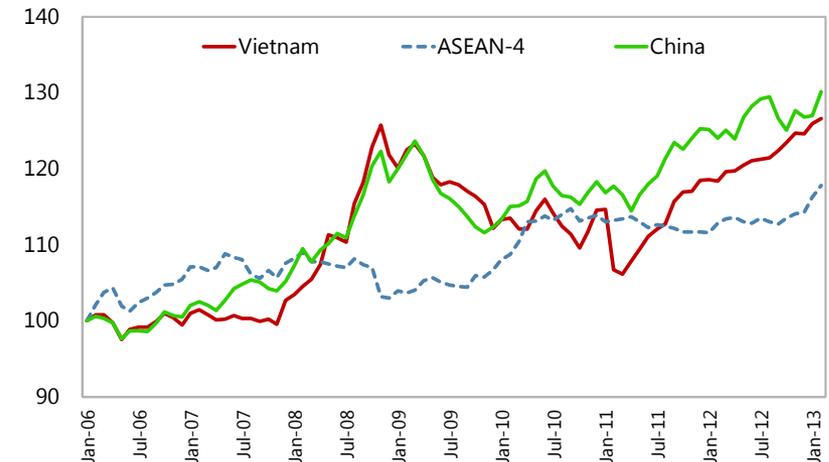
Sources: INS (Jan 1990-Jan 2012) and APD Core (Feb 2012-Jan 2013)
1/ ASEAN-4 includes Indonesia, Malaysia, Philippines and Thailand.

BANK LENDING RATES RESPOND WELL TO POLICY RATES

BUT CREDIT CHANNEL IS IMPAIRED

Vietnam: Interest Rates
(In percent)

Legend:
— Average bank lending rate
--- 1-month interbank rate
— Refinance rate
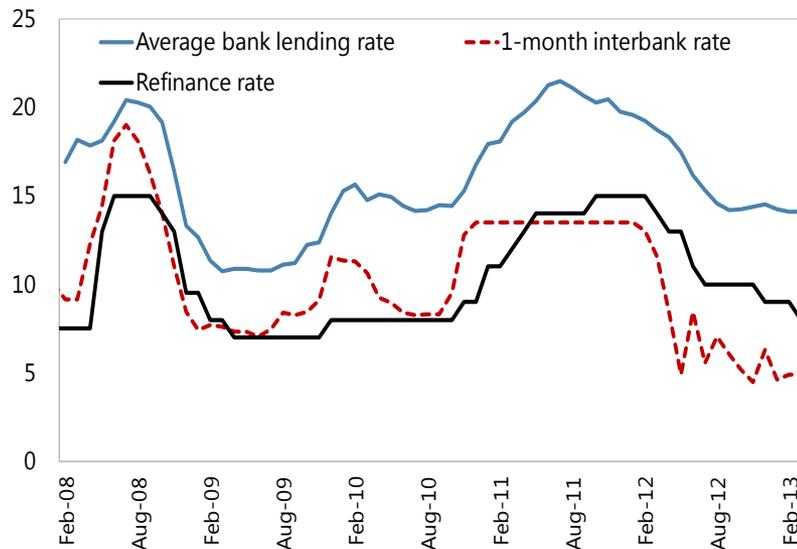
Source: Vietnamese authorities

Vietnam: Credit-to-deposit Ratio
(In percent)

Legend:
— Credit/deposit
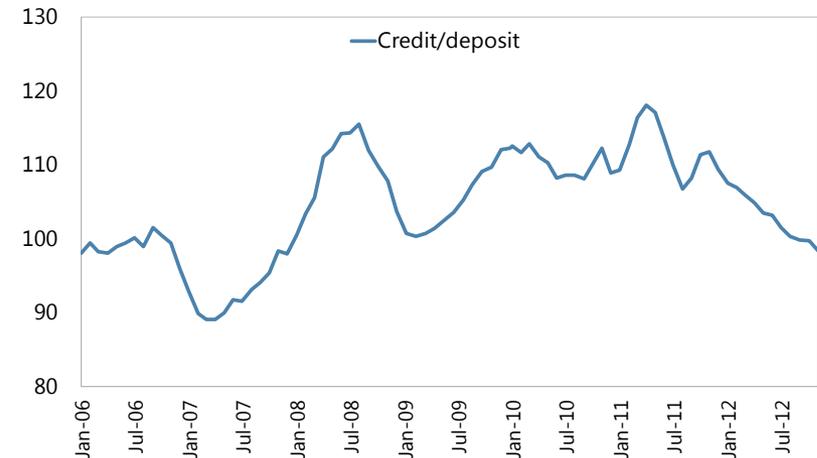
Source: Vietnamese authorities

Challenge 3: Raise international reserves to adequate levels
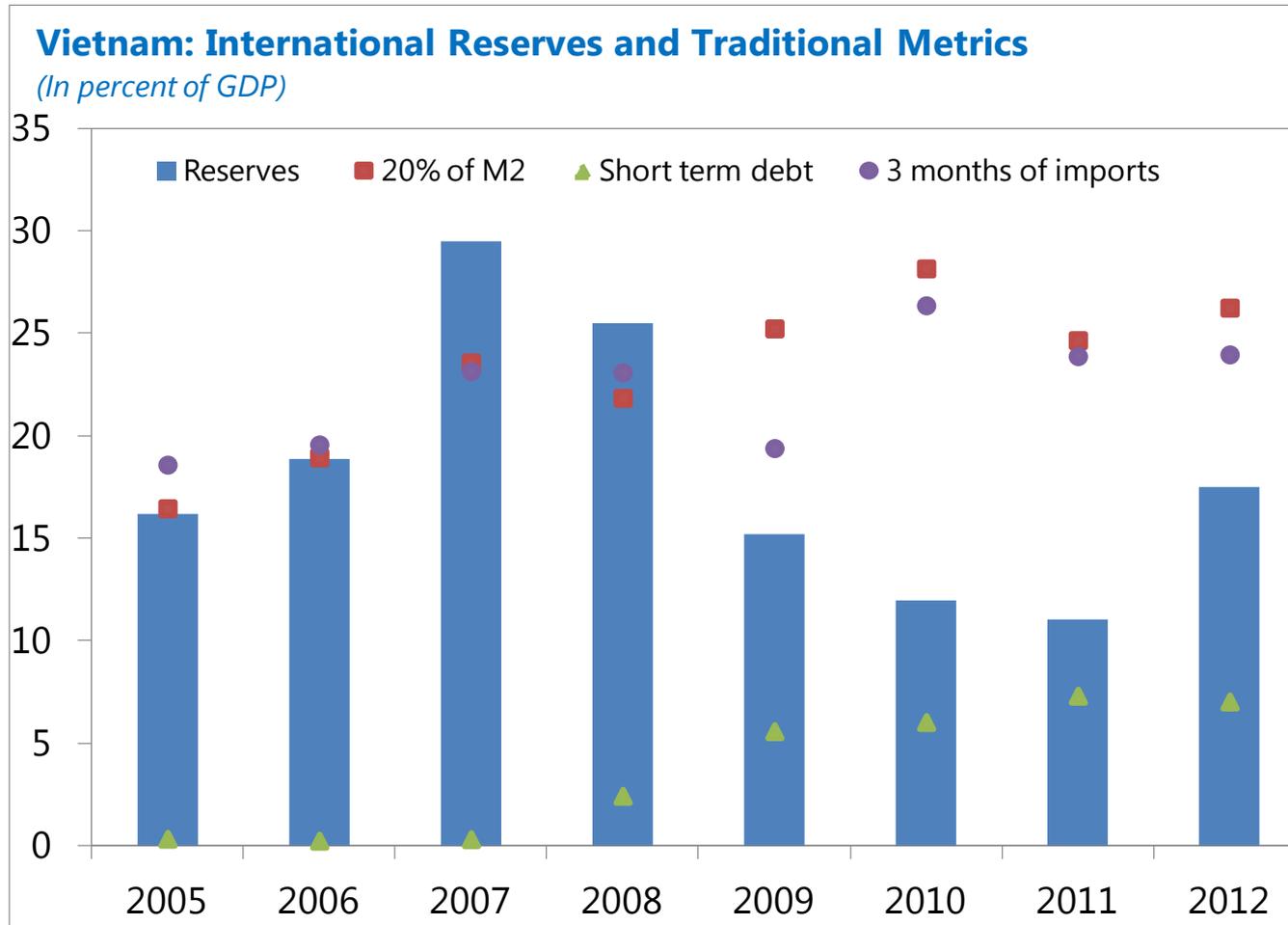
Vietnam: International Reserves and Traditional Metrics
(In percent of GDP)

Legend: ■ Reserves ■ 20% of M2 ▲ Short term debt ● 3 months of imports

Framework that can meet the challenges

- Fit multinomial logit for exchange rate regimes, using adjusted probabilities as instruments
- Time fixed effects
- Global and Asian LICs. Time period: 1990-2008

	Inflation				Growth				Growth Volatility			
Hard Peg	-0.053	(-2.25)**	-0.047	(-1.18)	-0.032	(-3.07)***	-0.029	(-1.97)**	0.038	(2.66)***	0.071	(2.14)**
Intermediate Regime	-0.061	(-3.46)***	-0.102	(-2.79)***	0.018	(0.99)	0.031	(0.92)	0.014	(1.31)	0.017	(0.69)
Asia			-0.020	(-1.08)			0.006	(0.60)			0.023	(2.21)**
Asia Int. Regime			0.081	(2.09)**			-0.030	(-0.84)			-0.016	(-0.64)
Lagged Inflation	0.612	(12.78)***	0.634	(10.37)***								
Lagged Growth					0.274	(3.79)***	0	0				
Money Growth	0.009	(3.97)***	0.009	(3.69)***								
Real GDP Growth	-0.183	(-2.74)***	-0.187	(-2.43)**								
Trade Openness	0.008	(1.33)	0.008	(1.14)	0.013	(2.03)**	0.017	(1.58)	0.006	(1.48)	-0.001	(-0.13)
Government Balance					0.127	(2.77)***	0.124	(2.64)***	-0.101	(-2.26)**	-0.131	(-1.92)*
Tax Ratio					-0.137	(-3.35)***	-0.167	(-2.12)**	0.011	(0.36)	0.063	(0.77)
Investment Ratio					0.100	(3.85)***	0.109	(3.25)***	0.304	(4.09)***	0.277	(3.09)***
Terms-of-trade Growth									-0.015	(-0.91)	-0.034	(-1.34)
Avg. Years of Schooling									0.001	(0.64)	0.002	(0.90)
Population Growth									0.278	(1.84)*	0.467	(1.89)*
Initial/U.S. income									-0.009	(-1.70)*	-0.018	(-1.55)
Observations	1133		1133		516		0		495		495	
R-squared	0.72		0.68		0.23		0					

Empirical results: Intermediate regime performs best

Performance Ranking	Inflation	Growth	Growth volatility
Intermediate Regimes	1	1	1
Hard Pegs	2	2	2
Floats	3	1	1

Inflation

- hard peg: -5.3
- inter. regime: -6.1

Growth

- hard peg: -3.2
- inter. regime: 1.8

Growth Volatility

- hard peg: 3.8
- inter. regime: 1.4
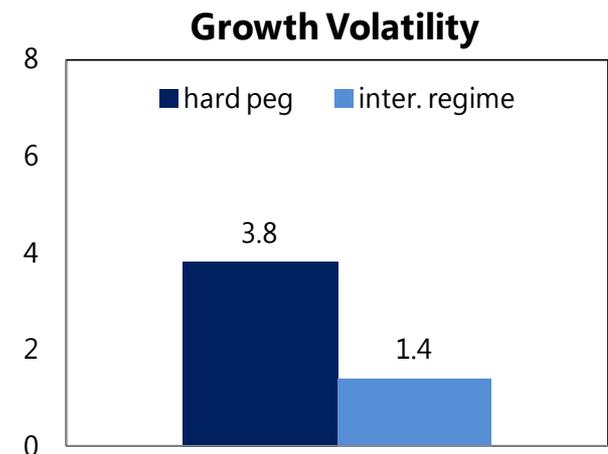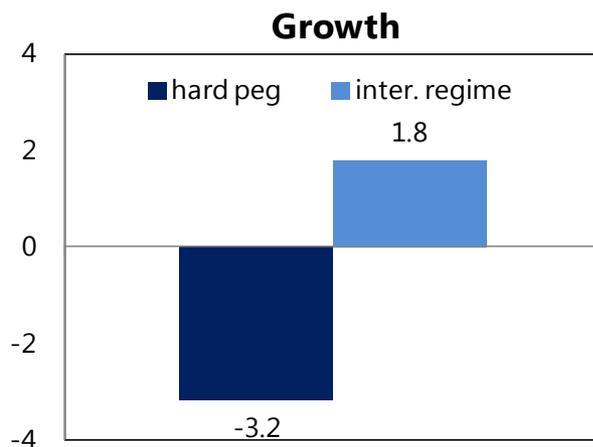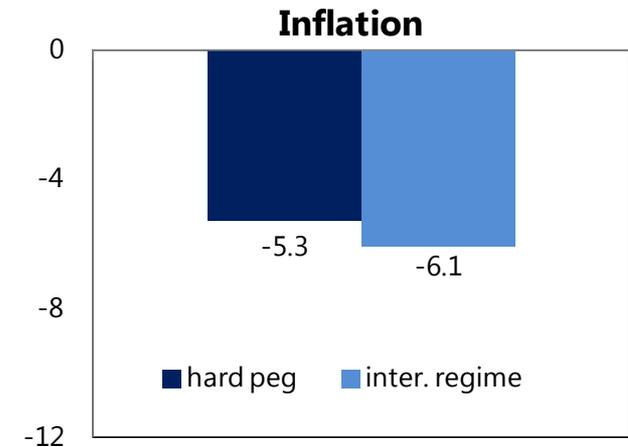
Characteristics of desired monetary policy framework for Vietnam

1. Clarify low and stable inflation as priority
2. "Managed floating" with increasing flexibility (wider trading band) over time
3. Supporting role for policy interest rate (corridor) and sterilized intervention
4. Phase out administrative controls
5. Clear monetary policy communication
6. Aim to transition toward explicit inflation anchor at distant future

To achieve a desirable monetary policy framework

- SBV law should
  - Simplify monetary policy mandate. Low and stable inflation should take priority.
  - Increase operation autonomy
  - Strengthen accountability framework

To help establish policy credibility

- A clear communication strategy
  - Regularly explain to market rationale behind policy framework, objectives, and action
  - Goal is for market to anticipate correctly how SBV will react to economic disturbances
  - Products: clear and forward-looking policy statements (e.g. with forecasts), quarterly reports

Possible issues for discussion

- Making inflation the primary objective

- Operational autonomy with accountability

- Reliance on market-based instruments

- Exchange rate flexibility

- Monetary policy communication