

## IV. MONETARY POLICY IN TRANSITION

Monetary Policy is becoming increasingly important in Viet Nam as the transition to a market economy evolves and the role of direct or administrative controls is reduced. In a market economy, monetary policy becomes the single most important policy instrument to effect short-term macroeconomic policy directions.<sup>50</sup>

Monetary policy operates primarily through the interest rates set by the State Bank of Viet Nam that influences both the amount of savings and the level of investments undertaken in the economy. Higher interest rates retard investments and provide the incentives for increased levels of savings. During 2004, for example, loans and investment demands were relatively too high under the influence of interest rates that were too low, i.e. below the neutral rate, and the rate of inflation accelerated.

In overall terms, monetary policy determines the rate of inflation in the economy, assuming that independent monetary policy is selected as a desired policy option from the 'trilemma'<sup>51</sup> facing all countries. In an economy largely dependent on the market, inflation becomes the single most important target for independent monetary policy.<sup>52</sup> A secondary target can be the full employment of resources, if inflationary expectations are not a constraint. Inflation expectations and the output gap - the spare room the economy has between what it is actually producing and what it could potentially produce - go into the inflation process. But inflation expectations tend to be more important than the output gap in determining future inflation. If inflation expectations were to rise that development by itself would tend to push up the inflation rate and it might take a very long time before the output gap would be able to offset prevailing inflation expectations. The relationship between these two objectives is commonly thought of in terms of the Taylor Rule.<sup>53</sup>

### Progress since the Beginning of *Doi Moi*

Viet Nam has generally experienced modest inflation following the very high inflation of the early years of *Doi Moi* reform program, which serve as a useful reminder of the effects of overly accommodative monetary policy. Inflation since the early 1990s has been modest, averaging 6.5 percent per annum since 1992 and ranging from -1 percent to 17 percent. It peaked at 350 percent in 1988 during the initial years of price liberalization which were not restrained by appropriate monetary policy (see Figure 4.1).

The Vietnamese currency, the dong, is a fiat currency.<sup>54</sup> Viet Nam is notable in that it is a country that utilizes two currencies - the dong and the U.S. dollar. The extent of U.S. dollar usage is not documented and has to be implied from

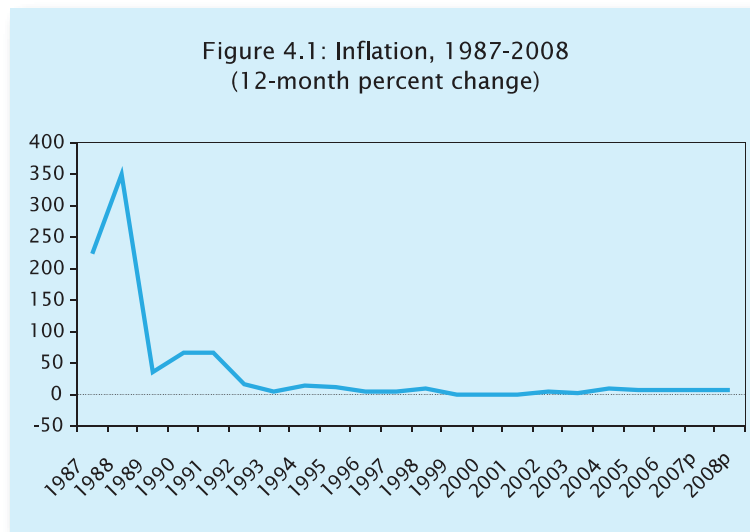
<sup>50</sup> Longer-term development policies are largely reflected in fiscal and budgetary policies, for example, the share of current expenditures allocated to health and education. Fiscal and budgetary policies generally require a medium-term focus of 3-5 years, in order to achieve effective results.

<sup>51</sup> The 'trilemma' indicates that a country can choose two out of three desirable policy options but cannot choose all three ((this concept is generally attributed to Robert Mundell (1961, 1963)). The three desirable policy options are open capital markets, fixed exchange rate, and independent monetary policy to address domestic issues such as inflation targeting. For most flexible and effective policy implementation, the choice is often in favour of open capital markets and independent monetary policy while giving up the fixed exchange rate policy, as practiced, for example, in Viet Nam, New Zealand, and Canada. If a fixed exchange rate is chosen, as in Hong Kong, for example, monetary policy must be focused on supporting that fixed exchange rate and so cannot be used to address domestic issues such as inflation and competitiveness.

<sup>52</sup> This is often referred to as inflation targeted regimes. Such regimes reflect the fact that inflation is everywhere and always a monetary phenomena as first understood and enunciated by Milton Friedman (1953).

<sup>53</sup> The Taylor Rule indicates in its simplest form that interest rates should be set under normal conditions at a level equal to the current rate of inflation plus an expected real return. To this neutral rate, neither expansionary nor restrictive in its impact on the economy, must be added the difference between the actual rate of inflation and the targeted rate of inflation. For example, if the neutral rate were assessed to be 9%, and actual inflation were running at 8% relative to the targeted rate of inflation of 6%, then the Taylor rule would indicate that the appropriate interest rate should be set at 11% to reduce the demand pressures in the economy and thereby gradually lower the rate of inflation to the targeted level (Taylor, 1993).

<sup>54</sup> The value of a fiat currency is dependent solely on the trust of the people of Viet Nam. There is no backing for the currency. As such you cannot take your holdings of dong to the State Bank of Viet Nam and demand a given amount of gold in exchange. At the same time, the dong is sanctioned by the Government of Viet Nam as the legal currency. From its issuance the Government collects substantial seigniorage (the difference between the face amount of the notes and coins and their costs of printing and minting), or tax revenues.



Sources: GSO, staff estimates (e) and projections (p).

**55** Banks must provide for U.S. dollar liquidity in addition to dong liquidity, the latter being more easily supported by the State Bank of Viet Nam. The operational concern is that illiquidity of the banks in U.S. dollars could result in a claim on Viet Nam's foreign currency reserves. Foreign currency reserves are designed to protect the economy from disruptions in export receipts or disruptions in foreign currency credit line renewals and to thereby allow timely payments and to permit continued importation. As such, Viet Nam's international reserves may not be adequate to cover both these international risks and the risk of illiquidity of domestic banks in U.S. dollars.

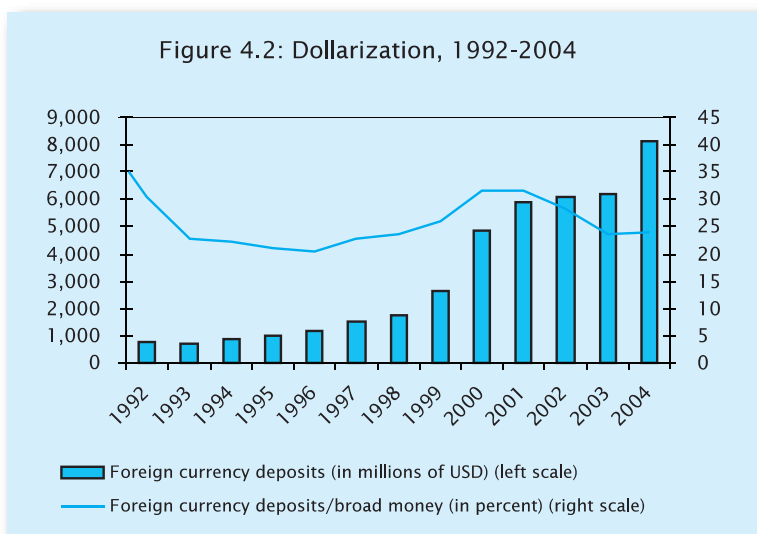
**56** Seigniorage is lost from the foreign currency in circulation in Viet Nam. Seigniorage is the difference in the face value of the notes and coin in circulation less the cost of printing and coinage that generally is reflected in the profits of the State Bank of Viet Nam which in turn are revenues for the Government's budget. These profits accrue on the increased issuance of currency in circulation in each year. Assuming the ratio of foreign currency in circulation to deposits in foreign currency is the same as that in dong, foreign currency in circulation would be equivalent to 49.5 trillions of dong, representing about 6 percent of GDP in 2005. With monetary aggregates programmed to grow by at least 15 percent, this form of seigniorage losses could amount to about one percent of GDP.

the ratio of deposits denominated in U.S. dollars to broad money and is often referred to as the degree of 'dollarization' of the economy. Dollarization, measured at its peak in 1991 at 41 percent following the macroeconomic stabilization, appeared to reflect uncertainties concerning the valuation of the dong. In the mid 1990s, dollarization fell to between 20-25 percent before rising in the aftermath of the Asian currency crisis in 1997. In recent years, dollarization has, for reasons of supply and cost, generally averaged about 28 percent (see Figure 4.2).

Foreign currency deposits in Viet Nam are generally held in the form of time deposits as a protection of the purchasing power of assets. U.S. dollar denominated assets are generally seen as a valuable diversification of assets to safeguard against dong denomination risks and, accordingly, increase together with perceptions of dong related risks. But recent usage of the U.S. dollar appears to also reflect the attractiveness of asset substitution as Viet Nam is becoming more integrated with the world economy. Allowing residents to hold foreign currency deposits enhances the credibility of the macroeconomic and monetary policy stance in Viet Nam. At the same time, there are costs arising from the use of the U.S. dollar as such use represents an increased risk for bank liquidity and safety<sup>55</sup> and a loss of seigniorage in Viet Nam that could amount to as much as one percent of GDP.<sup>56</sup>

### Recent Developments in Monetary Policy

The real return on 3-month dong deposits (nominal annual rates less the rate of inflation at year end) has averaged 4.3 percent over the 1992-2004 period (see Figure 4.3). This average rate has provided savers with a substantial real return and reflects an effective and appropriate monetary



Sources: State Bank of Viet Nam, IMF, and staff estimates

policy. However, it should be noted that the upsurge in inflation in 2004 yielded a negative real return to savers of 2.6 percent on 3-month deposits and this negative situation is being gradually addressed with higher interest rates and a gradual reduction in the inflation rate.

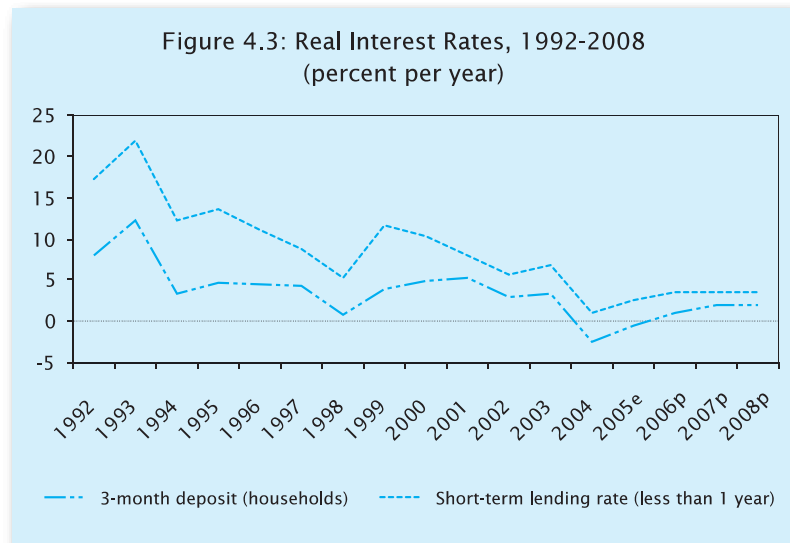
Looking at the short term lending rates, the real cost of funds (nominal lending rates less the rate of inflation) has averaged 10.3 percent over the period of 1992-2004 (see Figure 4.3). This has meant that borrowing has carried a substantial real cost. However the real cost over that provided by the banks to the savers was substantial (some 6 percentage points or 600 basis points) and reflects the high costs of intermediation by the banks in Viet Nam. A more competitive banking system could substantially reduce these real borrowing costs.

Looking ahead, we can project that inflation will gradually be brought under control and be reduced from 8.1 percent in 2005 to 6 percent in 2008. With this reduction of the inflation rate, the real return on short term deposits will be restored to 2 percent by 2007 while the real short-term lending rates will increase to 3.5 percent by 2006. These projected adjustments should be sufficient to restore monetary and price stability in Viet Nam.

### Recent Developments in Money Supply

The process of monetary creation can be reviewed from the monetary survey for Viet Nam as shown in Appendix Table 9. The monetary survey is created by combining the balance sheets of the State Bank of Viet Nam with those of commercial banks.<sup>57</sup> The key monetary and credit aggregates are not stable because of the variations in the degree of monetization of the

<sup>57</sup> While all their assets and liabilities are combined, inter-bank transactions are eliminated to prevent double counting; as such the resulting balance sheet reflects the position of the banking system vis-à-vis all other parties.



Sources: State Bank of Viet Nam, IMF, staff estimates (e) and projections (p)

economy, the uneven progress in modernization of financial instruments and institutions, and the rapid internationalization of the banking system that is now underway. For these reasons interest rates serve as the best benchmarks for the stance of monetary policy as analyzed above.

Nevertheless, the trends are broadly similar. In 2004, for example, there was a sharp acceleration in the growth of total liquidity which rose by over 30 percent relative to more normal growth rates of 20-25 percent. In addition, the lending to non-governmental sectors accelerated to over 40 percent in 2004, again from a more normal growth rate of 20-25 percent in previous years. Both of these developments were sufficient to signal the inflationary problems that emerged in 2004. At the same time, the inflationary pressures were more clearly portrayed from the analysis of the interest rate developments as described above.

## Regulatory Outlook

The structure of the commercial banking sector in Viet Nam will continue to present major regulatory challenges in the period ahead. SOCBs will require strong administrative support to develop appropriate credit cultures that can maintain continued low levels of non-performing loans (NPLs)<sup>58</sup> Normally such credit cultures can only be created through market forces which lead to governance focused on profit incentives by the private sector. Commercial banks generally work more sustainable with non-governmental ownership, which means that the needed credit culture is enforced through shareholders' interests in line with the market.<sup>59</sup> The implementation of the partial equitization program for the SOCBs can be helpful but has, in effect,

<sup>58</sup> Banks had earlier reported NPLs based on standards that were significantly lower than internationally acceptable ones. The State Bank's Decision 493 of April 2005 has since raised the classification and reporting on NPLs to international standards. This is expected to bring assessments of credit quality closer to international standards (World Bank, 2005b).

<sup>59</sup> For a discussion of this issue, see La Porta, Lopez-de-Silanes and Shleifer (2000).

been starting very slowly.<sup>60</sup> The soon to be applied WTO rules on subsidization should help to harden the budget constraints for SOEs and strengthen the hand of SOCBs in turning down loan applications from SOEs that are not creditworthy. The continued public ownership of these SOCBs is further complicated by the fact that the State Bank of Viet Nam, the bank regulator, is also the agency effecting ownership rights. These circumstances create an inherent conflict of interest between the exercise of regulatory forbearance and ownership responsibilities which could encompass increased capitalization as a policy choice. As a result of this situation, the regulatory oversight over SOCBs by the SBV can be expected to pose major challenges over the coming years.

<sup>60</sup> Vietcombank, one of the largest SOCBs, has issued convertible bonds worth 1.3 trillion dong (US\$820 million) as a first step towards equitization. The State's share in Vietcombank will be reduced gradually to about 70 percent and eventually to 51 percent by 2010. Two other SOCBs plan to issue bonds soon to shore up their capital before equitization. Equitization of all SOCBs is scheduled for completion by 2010 (World Bank, 2006a).