Monetary and Exchange Rate Policy in Vietnam: Some Challenges

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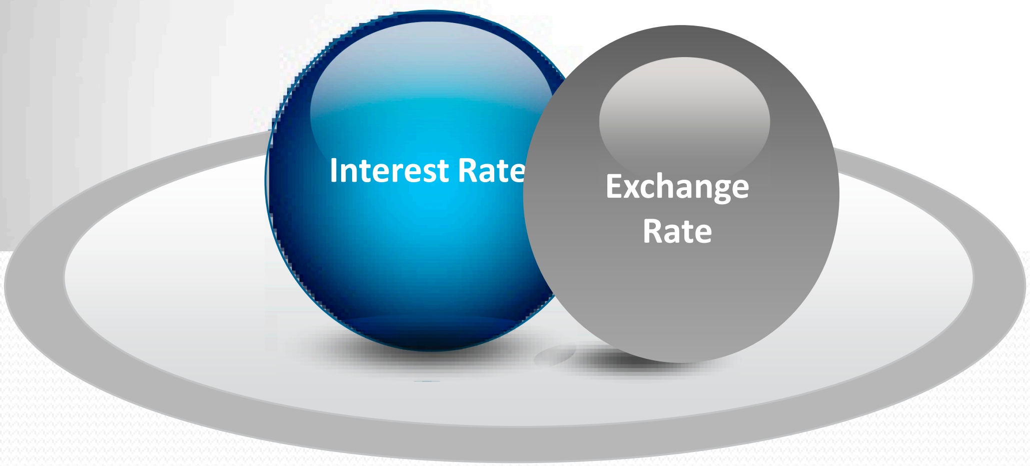

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Outline

- Objectives and Instruments
- Monetary and Exchange Rate Policy 2007-2010
- Some possible reforms

Monetary Policy Objectives

New SBV Law has streamlined objectives

- Greater focus on inflation as primary objective.

- Practically, growth (employment) and financial sector stability will always remain important.

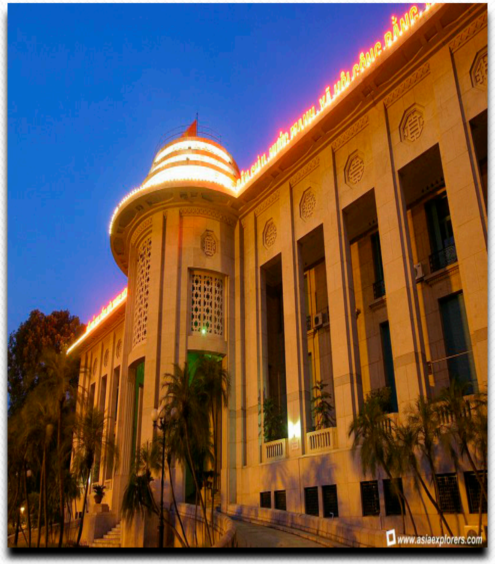
Instruments: Monetary Policy

Conventional View:

- Long term interest rates important for an economy:
    - Affect value of assets and decisions on consumption, saving and investment.
- Long-term interest rates are a function of expected short-term interest rates
- If central bank can influence expectations of future short-term interest rates, it can influence pace of economic activity.

Instruments: Monetary Policy

Implications:



- Central Banks try and influence the level of short term interest rates. (“Operational Target”)
- Establish policy rates (US: Fed Funds Rate; Thailand: One-day Repo Rate) to signal its target for short term interest rates.
- Use monetary policy statements to signal future changes in path of short-term interest rates.

Instruments: Monetary Policy

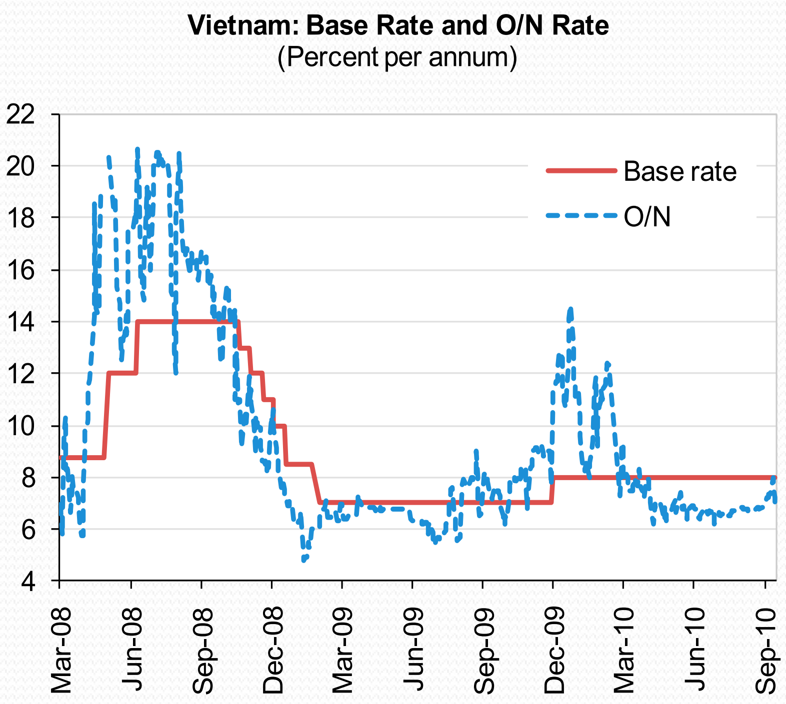
In practice:

- Central banks use a broader array of instruments (especially where monetary transmission mechanism weak)
- Reserve requirements, moral suasion, credit growth targets, prudential regulations all deployed (QE in advanced economies)
- However, over reliance on these instruments can be inefficient (excessive volatility, higher transaction costs, credit misallocation, less transparency, greater uncertainty)

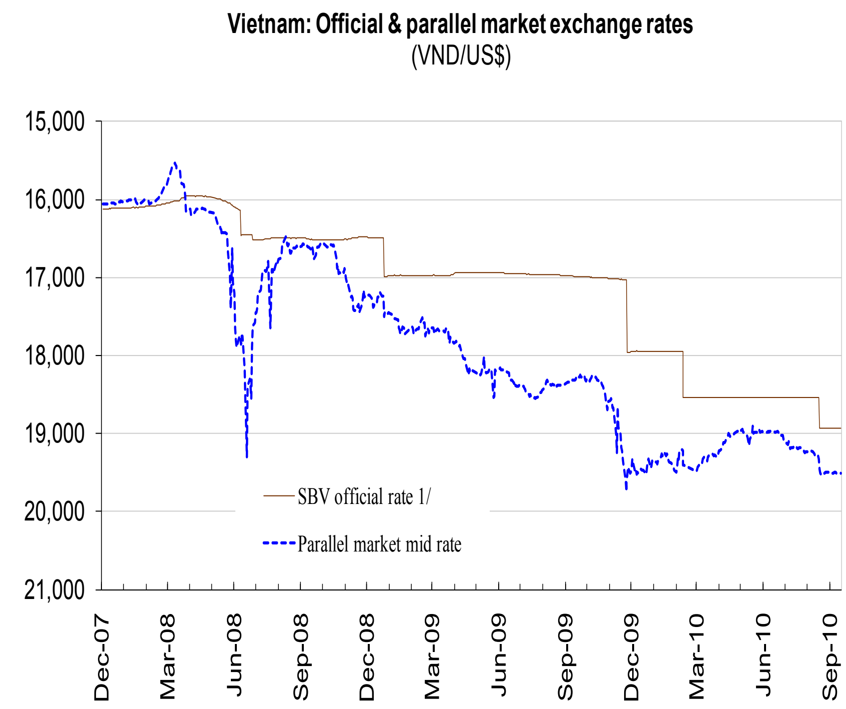
Instruments: Exchange Rate Regime

- Many options (fixed, bands, crawling pegs, managed float, floating)
- Each has different implications for monetary policy (the greater the flexibility of the exchange rate, the greater the discretion for monetary policy)
- Key: monetary policy must be consistent with exchange rate regime
- Emerging markets have been moving to more flexible exchange rate regimes (to allow greater discretion over monetary policy)

Monetary and Exchange Rate Policy, 2007-2010



Sources: SBV and commercial banks



Sources: SBV and local gold shops

Monetary and Exchange Rate Policy, 2007-2010

- Monetary Policy:
  - Policy rates used actively in early 2008, but less so since.
  - Monetary policy has been more responsive than policy rates suggest.
    - OMO's used to tighten/loosen liquidity (driving interbank rates far from policy rates on occasion)
    - Moral suasion, credit targets, and regulations also deployed.
  - Inflation in 6-10 percent range considered acceptable

- Exchange rate:
  - Formal peg with (now) relatively narrow band.
  - Peg adjusted relatively frequently to accommodate pressure on dong
  - Trading outside band tolerated, as means of absorbing pressure
  - Embedded expectation of declining trend in VND, largely accommodated

Monetary and Exchange Rate Policy, 2007-2010

SBV argues (with some justification) that:

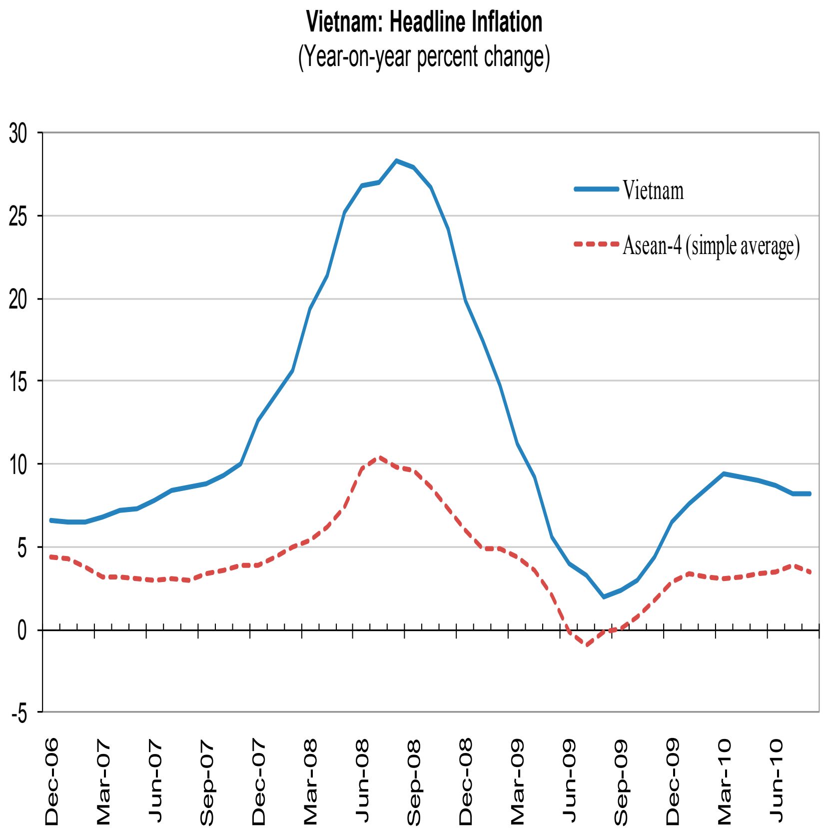
- Policy over this period reflected attempts to balance growth and inflation objectives under very difficult circumstances
    - External environment volatile and high political premium on maintaining robust growth.
    - Domestic markets underdeveloped and very sensitive to speculative shifts in sentiment.
    - Significant structural weaknesses in the banking system
- Given these conditions, outcome not too bad

Monetary and Exchange Rate Policy, 2007-2010

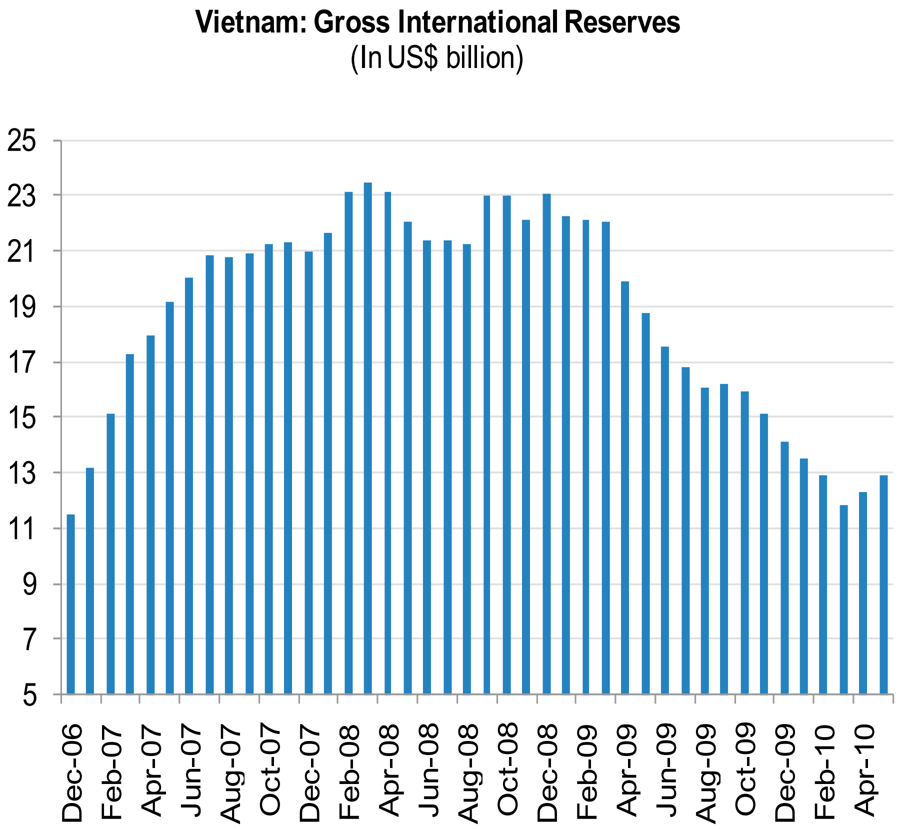
The main criticisms (also valid) were that:

- Policy was slow responding to developments, resulting in:
  - excessive build up of inflationary pressures (2007-2008)
  - excessive pressure on exchange rate and reserves (2009)
- Policy bias has resulted in an embedded expectation of a declining trend in the VND
- SBV was aware of risks, but consensus on policy action took time (Political constraints also biased use of policy instruments)

Monetary and Exchange Rate Policy, 2007-2010



Sources: GSO, CEIC and Fund staff calculation



Sources: SBV

Monetary and Exchange Rate Policy, 2007-2010

Furthermore:

- A reluctance to use policy rate adjustments resulted in:
  - Excessive volatility and uncertainty in financial system.
  - High spreads and shortening of maturity bank liabilities one symptom
  - A lack of transparency that has weakened confidence in macroeconomic management.
- Semi-permanent disequilibrium in foreign exchange:
  - Increased transaction costs and uncertainty for Vietnamese businesses
  - Undermined confidence in dong
  - Impaired Vietnam's standing among international investors

A way forward

- Two Key Challenges
  - Address inflation bias and embedded expectation of VND depreciation.
  - Make monetary and exchange rate policy more systematic and transparent
- New SBV Law provides framework to implement changes
  - Greater focus on inflation
  - Potential to streamline policy making and delegate authority to SBV
- How new law will be implemented will be key to realizing potential

A way forward: monetary policy

At operational level:

- Need to transition to greater use of policy rates to manage monetary policy.

- Three basic requirements:

  - SBV should be given greater authority to manage policy rates flexibly

  - A framework needs to be established to enhance control over short-term policy rates (Thailand may be a model)

  - Deeper, more liquid interbank markets need to be developed, as well as the SBV's institutional capacity to manage liquidity in these markets

A way forward: Exchange Rate Policy

- The key challenge is to create a more flexible exchange rate framework to address disequilibrium in foreign exchange market.
- Many options, but a combination of a more flexible central rate and wider band attractive.
- Has been used as a transition device by many emerging market economies
- Establishing the credibility of any new exchange rate regime important (implies appropriate initial central rate and support from monetary policy)

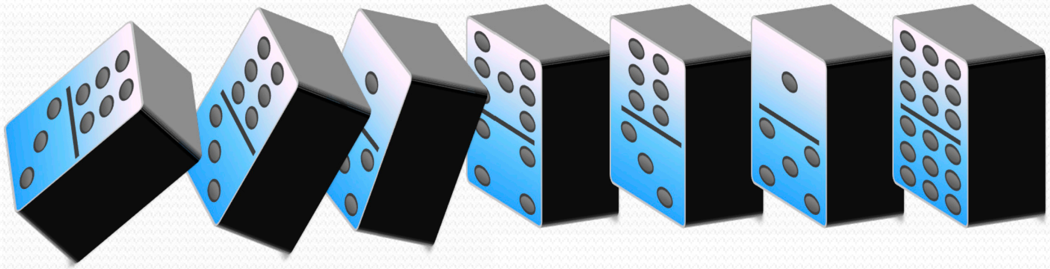
A way forward: monetary and exchange rate policy

Sequencing important:

- Operational changes need to be embedded in policy framework with a more stable price anchor
- Suggests priority on monetary policy reform:
  - Reduce inflation to ASEAN 4 average (break the devaluation bias)
  - Grant SBV greater freedom to adjust policy rates
- Banking system stability also a priority

Final thoughts

- SBV deserves credit for managing monetary and exchange rate policy under difficult circumstances.
- However, weaknesses in monetary and exchange rate policy framework have come with a significant cost
- New SBV law provides opportunity to create a more flexible formal framework for monetary and exchange rate policy.
- Let's not miss this opportunity



Thank you