

Monetary Policy in Vietnam:  
Alternatives to Inflation Targeting

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## **Abstract**

The focus of this paper is on the 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, and takes the position that the primary task of the central bank should be to achieve an appropriate mix of macro-prices that best supports rapid and sustainable economic growth. The feasible parameters of this mix are determined by the current state of Vietnam's transition to a more market-oriented economy and challenges posed by dollarization, financial repression, informal and underdeveloped financial markets, and rapid international economic integration.

An important finding is that critical elements remain missing in the body of knowledge, institutional arrangements, tools and rules needed to increase the effectiveness of monetary policy. The paper concludes by considering alternatives to the inflation targeting policy that has been widely adopted by central banks in both developed and developing countries, and proposes an alternative intermediate target – a stable and competitive real exchange rate – that is more appropriate for the coming period of greater openness and intensified competition in both domestic and export markets.

## 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

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## 1. Introduction

### *1.1 Monetary Policy for New Phase of Accelerated Globalization*

Vietnam, a transition economy that broadly followed the East Asian “developmental state”<sup>1</sup> model during the first fifteen years of its reform process known as *Doi Moi*, is entering a new phase of development. This new phase will likely see a speeding up of globalization, shaped by the terms of its trade agreements with bilateral and regional trading partners and accession to the World Trade Organization (WTO). The nature of the opportunities and risks presented during this phase are matters of great concern, especially to population groups that are least able to cope with volatility from external shocks. Recognizing these challenges, the government has launched extensive consultations to identify appropriate macroeconomic and monetary policies to help their nation weather successfully this period of unprecedented exposure to the vicissitudes of the global economy. To this end, the State Bank of Vietnam (SBV) also has prepared a plan on the banking sector’s international economic integration.<sup>2</sup>

This paper hopes to contribute to Vietnam’s search for policies that promote growth while keeping the macroeconomy on an even keel. Its specific focus is on the conduct of monetary policy: how it is made, and how it should be made. It examines the factors that should guide monetary policy, and takes the position that the primary task of the central bank during this coming period should be to maintain the right mix of macro-prices to

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<sup>1</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). Mkandawire further describes the developmental state as one that seriously attempts to deploy its administrative and political resources to the task of economic development.

<sup>2</sup> State Bank of Vietnam “Plan on International Economic Integration of the Banking Sector of Vietnam” issued together with Decision No. 663/QĐ-NHNN on June 26, 2003 (Decision of the Governor of the State Bank on the plan on international economic integration of the banking sector). Hereafter this document will be referred to as the SBV 2003 International Economic Integration Plan. The SBV argues that active participation in globalization and integration with the world economy will act as a locomotive to help Vietnam to grow and catch up with countries in the Pacific Asia region, strengthen the capacity of entrepreneurs, transform Vietnam’s industry structure, and improve factor mobility.

support rapid and sustainable<sup>3</sup> economic growth and structural change geared towards industrialization, modernization and higher value-added production of goods and services. Of course, the parameters of this mix are determined by 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.

An important finding is that critical elements remain missing in the body of knowledge,<sup>4</sup> institutional arrangements, tools and rules needed to increase the effectiveness of monetary policy. The paper focuses on two important gaps: the need to strengthen the central bank's knowledge base and develop rules for monetary policy that are realistic and geared towards the new challenges facing the Vietnamese economy. It considers alternatives to the inflation targeting policy that has been widely adopted by central banks in both developed and developing countries, and proposes a different intermediate target – a stable and competitive real exchange rate (RER) – that is more appropriate for the coming period of greater openness and intensified competition in both domestic and export markets. Maintained over an extended period, a stable and competitive RER promotes a pro-growth allocation of resources, 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 five 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. 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 by complementary fiscal, monetary, and industrial

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<sup>3</sup> Clearly, if growth is to be sustainable, it must be able to contain inflation.

<sup>4</sup> As described in Section 2.1.1, the government is operating somewhat in the dark as it attempts to manage aggregate liquidity.

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

policies. Fourth, it can have positive medium- to long-term impacts on structural change and development through a variety of channels: resource allocation, shifts in production techniques, growth of capital stock including stock of human capital (Frenkel and Taylor 2005)<sup>6</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 actually 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>7</sup> on resource allocation and the composition of output takes place through its influence, both direct and indirect, on key macro 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>8</sup> Enterprises in Vietnam have shown that they understand the powerful impact of price changes on profitability<sup>9</sup>, and therefore are likely to make long-term investment and production plans based on price signals that they believe to be permanent rather than temporary.

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<sup>6</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>7</sup> The long-term effects take into account the time lag from when investment decisions are made and productivity gains are realized.

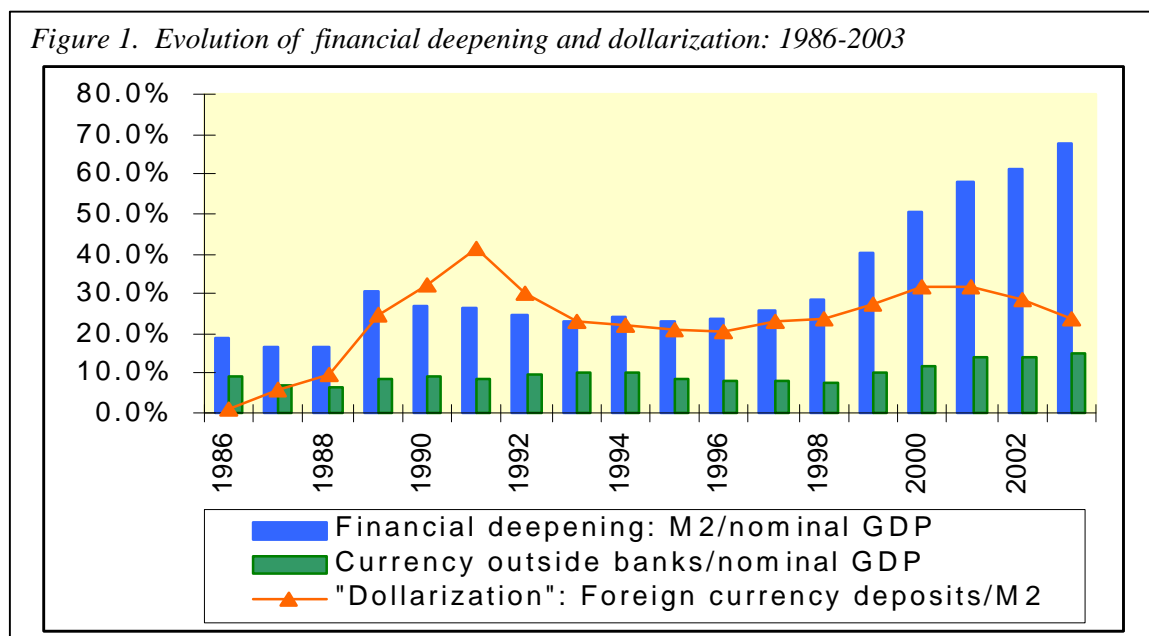
<sup>8</sup> The cost of capital goods and intermediate inputs affects the export/import price ratio.

<sup>9</sup> This can be demonstrated through simulations of Vietnam's input-output tables and through analysis of individual firms. For example, sensitivity analysis carried out by management consultants of three large firms in the state enterprise paper industry indicates that a 10 percent increase in product price will increase the firm's profit margin by between 64 and 121 percent (Packard 2004).

## 1.2 Vietnam's Central Bank: Main Tasks and Concerns

Reforms in Vietnam's monetary and financial sector have been an integral part of the *Doi Moi* reforms launched in 1989. Similar to China's reforms, they include the establishment of a two-tier banking system, gradual liberalization of interest rates and the exchange rate, decreased reliance on direct controls over credit growth, and greater emphasis on using indirect instruments of monetary policy (see Section 1.3). During the past 15 years, the government adopted prudent fiscal and monetary policies while permitting rapid credit growth when the threat of inflation receded. As a result, Vietnam was able to maintain a high rate of economic growth, macroeconomic stability and low inflation over a prolonged period (1990 – 2005).

This positive economic environment laid the groundwork and provided support for greater financial deepening (shown in Figure 1), as measured by the ratio of M2 to nominal GDP. The evolution of this ratio may be viewed as a proxy for public confidence in the state's macroeconomic management capability. Recently Vietnam's central bank has been taking advantage of the credibility that it gained in controlling inflation to quietly implement strategies to de-dollarize the economy, chiefly by making dollar deposits less attractive than dong deposits. SBV officials also have followed the





trend of other developing country central banks in pressing for greater independence and autonomy, and have shown great interest in learning more about inflation-targeting (IT) regimes.

The main duties of the central bank are outlined in the Law on the State Bank of Vietnam (hereafter SBV Law), which states that its core task is to stabilize the value of the currency. Two other essential and interdependent tasks decreed by the SBV Law are to 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). The SBV Law is interpreted by central bank officials as a mandate to control inflation and promote economic growth (Le Xuan Nghia 2005).

Traditionally SBV officials and the Vietnamese people have tended to favor a relatively strong (and therefore less competitive) exchange rate pegged to the US dollar because they believe that there is a tight link between the nominal exchange rate and the domestic price level. Exchange rate depreciation is seen to signal a potentially worrisome rise in the inflation rate. Vietnam has a strong domestic constituency for low inflation because people's memories have been seared by the difficult period preceding the *Doi Moi* (Renovation) reforms, when Vietnam grappled with hyperinflation and associated large depreciation of the parallel market exchange rate. In other words, public sensitivity to movements in the inflation rate stems from their earlier traumatic experience with hyperinflation.

Concerning other tasks mandated by the SBV Law, the safety of the banking system has become a greater worry as Vietnam enters the new phase of accelerated globalization. At issue is the capacity of the domestic banking system to compete under conditions dictated by the US-Vietnam Bilateral Trade Agreement (BTA) and WTO membership, and the adequacy of measures to protect the financial sector from destabilizing crises similar to the 1997-98 Asian financial crisis. The US-VN BTA establishes a time-bound roadmap for the gradual removal of restrictions on US bank participation in all banking activities in Vietnam including accepting deposits, providing loans, issuing credit cards, arranging money transfers, and so on. After 2010, US banks will be allowed to set up 100%-owned subsidiaries in Vietnam. As a result of this competition, the SBV 2003 International Economic Integration Plan document notes that a decline in the market

share of Vietnamese commercial banks is anticipated, because US and other foreign banks (which have requested the same treatment as US banks) have superior technology and better credit analysis and risk management skills. At the same time, central bank officials hope that competition from foreign banks will spur the banking system to reform and renovate, and that domestic banks will learn from their foreign rivals and restructure. In their view, exposure to foreign competition will speed up modernization of the banking sector, develop financial markets, improve management capability, and bring financial industry regulations up to international standards (SBV 2003 International Economic Integration Plan).

While banking issues are outside the scope of this paper, monetary policy's influence on financial sector development is important to note. This takes place through its impact on key macro prices such as the real exchange rate and interest rate differentials as well as through policy and institutional decisions regarding controls on cross-border capital flows and exchange rate policy. This in turn affects the growth path of the economy including the financial sector.

The third pillar of the SBV law – promoting socio-economic development while preserving the nation's socialist orientation – is in effect a declaration that the ultimate objective of central bank policy including monetary policy should be to promote the social well-being of the people and to expand their capabilities.<sup>10</sup>

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<sup>10</sup> I assume that the authors of the SBV Law are sympathetic to the “human development approach” articulated by the United Nations and reaffirmed in the government's 2002 Comprehensive Poverty Reduction and Growth Strategy (CPRGS) document. Development is “conceptualized as the broadening of people's choices” by expanding their “capabilities” to live a long and healthy life, to be well nourished and clothed, to be knowledgeable, to have access to resources and opportunities that ensure an adequate standard of living. Other important capabilities include the ability to have self-esteem, to be treated with dignity, and to be free from systematic social exclusion due to discrimination or other factors (UNRISD 2005).

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

Prior to 1989, as with other centrally-planned economies (CPEs), the State owned and controlled Vietnam's single-tier banking system, directed bank lending, and – due to scarce resources – imposed credit rationing. 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).

The SBV was the sole provider of domestic banking services through a vast branch network. Its task was to ensure that financial resources were allocated to economic units in accordance with the state economic plan. SBV offices functioned as the interface between state planning, the national budget, and various state entities that included some 12,000 state-owned enterprises (SOEs).<sup>11</sup> Lending decisions were not commercially based, and for this reason the SBV bank network had little experience with standard commercial banking functions such as credit analysis or risk management. During this period, domestic and international payment systems were so slow that payment by check between provinces often took from two to six months to clear<sup>12</sup>. As a result, many

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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).

<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).

enterprises ignored the check payment system and instead used couriers to make direct cash payments (World Bank 1991).

Vietnam's monetary history during the mid 1980s was marked by recurrent fiscal crises and government measures to monetize sharply rising fiscal deficits because revenue growth failed to keep pace with rising expenditures<sup>13</sup>. The state had great difficulty imposing fiscal discipline on its constituent parts. SOEs 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 8) 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 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

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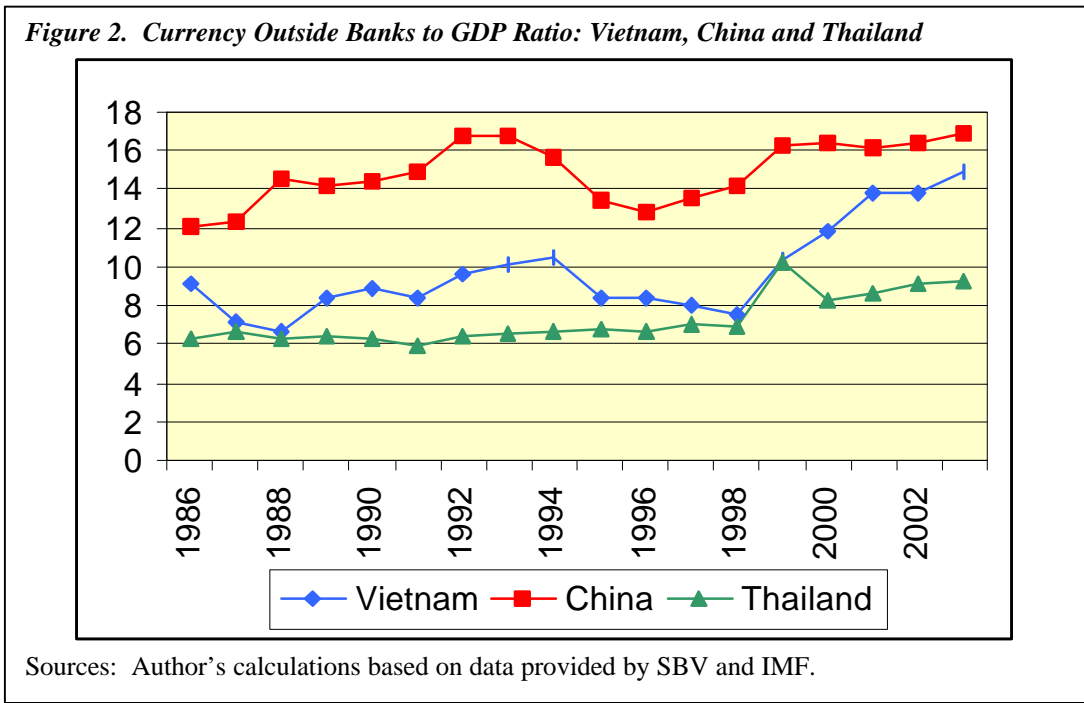
<sup>13</sup> The expenditures included the costs of maintaining a large military force, direct subsidies to SOEs, and indirect subsidies associated with price controls.

<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 *chiếm 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 that effectively gave them half or sometimes a third of the amount they could get in the open market (Beresford and Dang Phong 2000).

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.

To provide a comparative cross-country perspective, Figure 2 presents the change in the ratio of currency outside banks to GDP from 1986 to 2003 in Vietnam, China and Thailand. A more detailed discussion of possible interpretations of this ratio and factors that determine its evolution in Vietnam is provided in Section 2.1.1. The relatively high ratio found in China, broadly cycling between 12 to 17 percent, indicates that the economy remains largely cash-based and that GDP estimates may fail to adequately capture the size of the informal sector. Vietnam's ratio broadly cycled at a lower 6 to 10 percent band until 1988, reflecting public fears of a possible return to high inflation. As the State gained credibility about its ability to keep inflation under control, the ratio climbed steadily to over 14 percent by 2003. Another factor behind the rise may be



<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).

structural changes in the economy as well as underestimation of the size of the informal sector. Thailand had a lower ratio of around 6 percent that remained quite stable until the 1997-98 financial crisis. A less steep climb of this ratio (compared to Vietnam) from 2000 on may indicate that a structural shift is taking place in the Thai economy.

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 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 issued two ordinances on banking which established the objectives, duties and purposes of operations for each tier of the banking system. The SBV was given responsibility for state management of banking systems and assumed the duties of a central bank. The Commercial Bank Ordinance 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 responsibility for the operation and control of their finances and implementation of universal banking activities. As a result, the banking sector expanded rapidly and banks began to offer a wider range of services. By end of 1996 the financial sector consisted of 4 SOCBs, 52 joint stock banks, 23 branches of foreign banks, 4 joint venture banks, 62 representative offices of foreign banks, 68 credit

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<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.

cooperatives, about 900 people's credit funds, 2 finance companies, and 1 state-owned insurance company (IMF 1998).

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

Figure 3. Monthly inflation and interest rates, nominal and real: April 1989 – May 1990

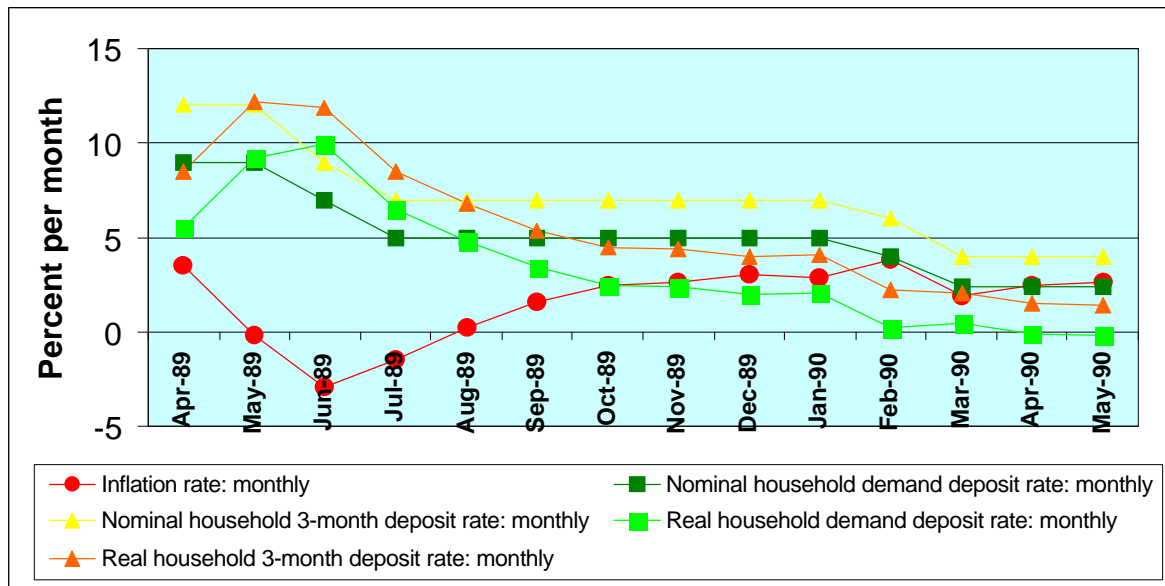
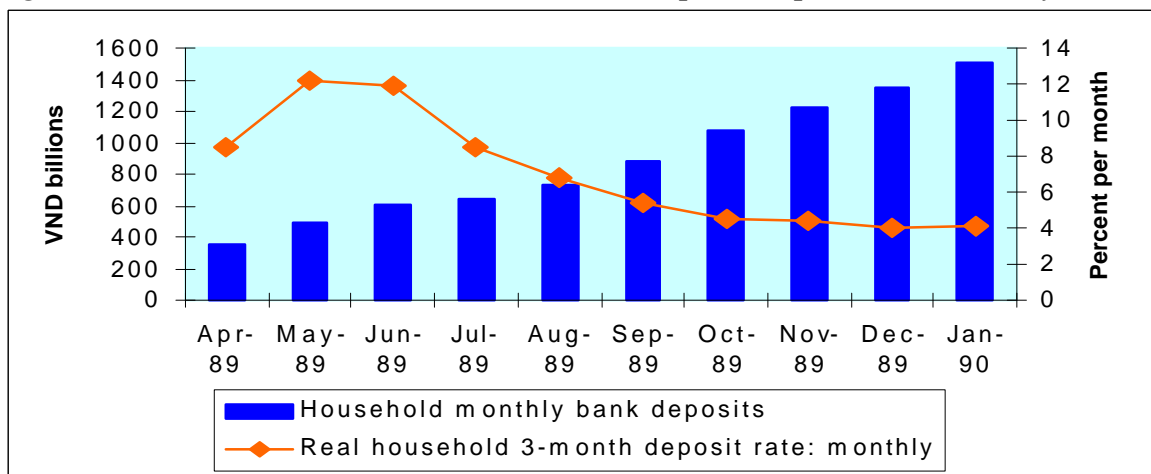


Figure 4. Real interest rate and household bank deposits: April 1989 – January 1990



Source: SBV, World Bank 1992

<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.

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 3). 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 4). 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 produced the following paradoxical outcome: the sharp rise in M2 as a share of nominal GDP (from 16.7 percent in 1988 to 30.5 percent in 1989) was accompanied by 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. That the same ratio could signal opposite things at different points in time suggests that historical and economic context should guide our reading of key monetary indicators.

The banking reforms gave the private sector access to formal banking services by allowing the establishment of new deposit taking institutions that included shareholding banks, urban credit cooperatives<sup>19</sup> (UCCs), and SOEs. By the end of 1989, six shareholding banks were registered with the SBV. A number of the shareholding banks

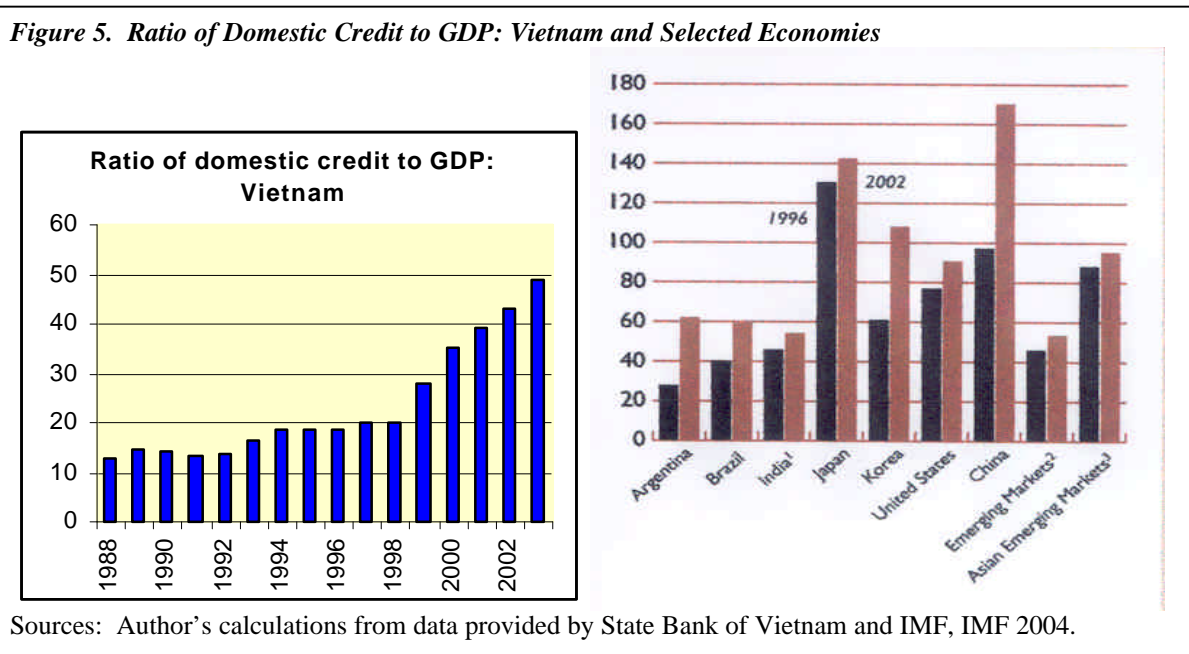
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<sup>19</sup> Growth of the UCCs were encouraged by local governments to intermediate local savings and to get around the inefficiencies of state sector banking services. By mid 1990, over 100 UCCs were in operation. A number of the UCCs went beyond the activities of a credit cooperative and functioned more like banks. Although some were established by professional managers with prior banking experience, many more UCC managers lacked banking skills. In contrast to the RCCs, UCCs operated outside the existing regulatory framework. Due to lack of experience, many UCCs provided short-term credit (usually three months, and mainly to cover working capital requirements) without carefully evaluating their borrowers' repayment capacity. Other UCCs misused funds and engaged in fraudulent activities, giving rise to highly publicized scandals that prompted massive withdrawals of deposits (World Bank 1991). Most UCCs have gone out of business because they lost public confidence and were unable to retain depositors.



had mixed ownership (SBV and private shareholders), with SBV shareholdings being gradually bought back by the private shareholders (World Bank 1991).

The SBV employs both direct and indirect instruments to conduct monetary policy. Direct instruments are thought to be more effective during the current phase of Vietnam's transition economy. Motivated by the desire to create more indirect instruments, and to further develop the domestic financial market, the SBV in 1994 established interbank markets for foreign exchange and short-term domestic bonds. Buying and selling rates in the interbank foreign exchange market are allowed to move within a band around an official reference rate that the SBV sets daily (World Bank 1997). Treasury-bill auctions were introduced in mid 1995 to allow market forces a greater role in determining interest rates.



Among the direct instruments, the SBV introduced bank-by-bank credit ceilings in 1994 to control credit growth. To give the banking system more flexibility, they allowed banks to trade their credit ceilings in 1996. The importance of the banking system in the economy is indicated in Figure 5, which presents the evolution of the ratio of domestic credit to GDP in Vietnam and in other selected economies for comparison. By 2003 the ratio in Vietnam is comparable to the emerging market countries but well below the Asian emerging market countries and considerably below Japan, Korea, and China.

## 2. The Macro Economy and Transmission Mechanisms

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

#### 2.1.1 Incomplete Information on Monetary Aggregates and Domestic Credit

The effective conduct of monetary policy using standard intermediate targets requires a much better understanding of actual transmission mechanisms in Vietnam than we have at present. The basic problem is incomplete information: we do not have reliable data on key variables contained in standard IS-LM equations that describe interactions between the goods market and the money market. Vietnam's ongoing structural transformation also obscures the picture<sup>20</sup>.

To illustrate: aggregate money supply and important components of the money demand function are unknown due to partial dollarization of the Vietnamese economy (Hauskrecht and Nguyen 2004) and inadequate information 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>21</sup>. For this reason the theoretical link between money and prices turns out to be difficult to verify empirically. Not surprisingly, a VAR analysis of inflation dynamics in Vietnam carried out by IMF staff found that the role of monetary aggregates on the CPI was not robust and provided little guide to monetary policy.

The reasons for this finding is easily seen with reference to the well-known Quantity Theory of Money (QTOM) identity

$$MV=PQ$$

where the pass-through from money (M) to prices (P) is complete and straightforward assuming that velocity (V) is constant. However, in Vietnam "true" M is an elusive variable. Broad money (M) is at minimum the sum of M2 (recorded by the SBV), foreign deposits held in banks (also recorded) and foreign currency holdings and gold in circulation (not officially recorded). It is also likely that the domestic and foreign

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<sup>20</sup> For this reason, it may be more realistic to assume that key parameters of the economy are better approximated by time-varying instead of fixed coefficients (Packard and Thurman 1996).

<sup>21</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.

currency will have different velocities (Hauskrescht and Nguyen 2004) and different (policy influenced) trajectories.

The implication for monetary policy is that it is not feasible to employ a monetary aggregate such as M2 as an intermediate target. The authorities cannot know how to manipulate M2 to get the desired impact on the price level because the relationship between M2 and the inflation rate is neither close nor stable. It also is not possible to estimate the time lag between the transmission of a monetary policy impulse and its impact on the real economy. While monetary aggregates are not suitable intermediate targets, they should be utilized as monitoring variables that aid the analysis of economic and financial conditions, so policymakers can better assess the response of key economic players to monetary policy impulses. As shown below, careful analysis of changes in velocity is especially useful in increasing our understanding of transmission mechanisms and developments in the economy that may have policy significance.

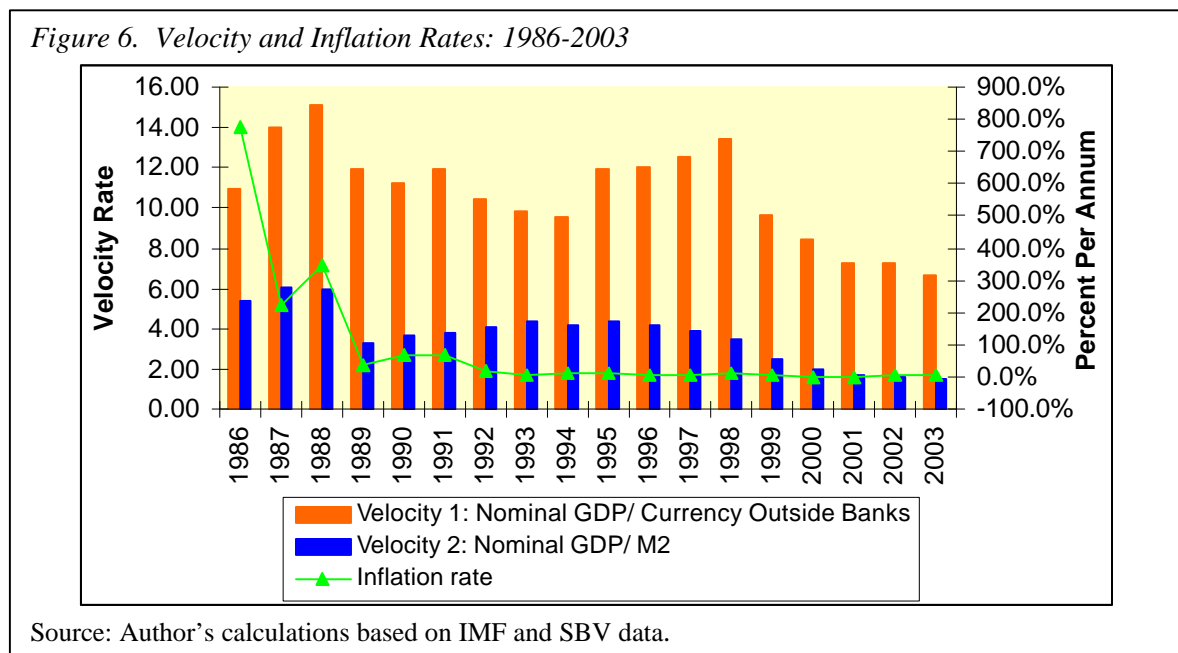


Figure 6 presents the velocity time path for currency outside banks (V1) and for total liquidity M2 (V2), which includes currency outside banks, domestic currency deposits and foreign currency deposits. It is apparent that V1 and V2 have different trajectories arising from the different effects of policy on narrowly defined and more broadly defined money. Two main counteracting influences on velocity should be noted. First, ongoing

structural reform in the financial sector and improvements in the payment system have the effect of raising velocity. Offsetting this is greater confidence in the domestic currency (due to success in bringing inflation under control), which encourages households and other economic agents to switch to the domestic currency, causing a decline in velocity and greater monetary deepening (see Figure 12). The marked decline in V2 from 1999 on may reflect a dishoarding of US dollars and gold as households and other economic actors increased their participation in the formal banking system.

In a multiple currency economy, declining V1 is consistent with financial sector development because it signals a portfolio shift away from gold and US dollars towards the domestic currency. As shown in Figure 6, portfolio shift appears to dominate movements in V1 during this phase of economic transition, and the observed episodes of decline in V1 correlates with the period of greater success in inflation control. At the same time, the rise in V1 from 1994 to 1998 is difficult to interpret, because it is not clear how much of this rise is attributable to improvements in the payment system (and corresponds to the decline in V2), and how much is attributable to lack of confidence in the value of the domestic currency. The observed decline in V1 during the period from 1999 to 2003 may reflect greater growth in the informal economy that is not recorded as GDP by the government statistical office, given that during this period the growth rate of currency outside banks averaged 28 percent while the nominal GDP growth rate averaged only 11 percent. It may also be that the GDP deflator is underestimated.

The other critical information gap has to do with the provision of domestic credit. Given the existence of financial repression and credit rationing in the Vietnamese economy, it is reasonable to assume that a significant portion of interfirm credit is extended to credit constrained enterprises that would have preferred to receive bank credit to finance their working capital requirements. However, there are no reliable estimates of the magnitude of interfirm credit as a percent of aggregate credit creation,<sup>22</sup>

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<sup>22</sup> Empirical evidence on interfirm credit is sparse, but what is known indicates that the amount is not trivial. A 2002 survey of 1119 nonstate enterprises found that from 1994 to 2002, 46 percent of credit constrained firms managed to access external funds. Analysis of this survey data also suggests that the informal sector may represent 30 – 35 percent of the credit market (Rand 2004). With respect to firms in the state sector, a 1997 survey of 3000 state-owned enterprises (SOEs) conducted by the Ministry of Finance revealed that on average, accounts payable and accounts receivable represented 35.5 and 17.3 percent respectively of turnover.

and the quality of their accounts receivable (which may pose a significant risk to the banking system) is not known. For this reason, the central bank is somewhat in the dark as it attempts to manage aggregate liquidity, and is dependent on a limited set of indicators to determine if it is on the right track. Complicating this task is the unclear link between bank credit growth, the inflation rate, and actual borrowing by business enterprises (see Figure 4) due to the coexistence of formal and informal financial markets, and the role of interfirm credit. During periods of structural transformation driven by regulatory change and rapid growth in the range of financial services provided, the application of standard procedures to assess whether a high rate of credit growth is indeed inflationary and warrants concern is likely to mislead. Policy analysts need supplemental information<sup>23</sup> to be able to distinguish between a genuine increase in aggregate credit (due for example to lax monetary or fiscal policy), and change in the composition of credit due to the increasing formalization of credit (more loans recorded by the formal banking system) and related decline in lending in the informal sector (fewer unrecorded loans).

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<sup>23</sup> The additional information needed are: representative household and enterprise survey data conducted at least once every two years to determine if there has been a significant change in financing source (such as a major shift from borrowing in the informal financial sector to borrowing in the formal financial sector). Other useful information includes changes in financial sector regulations that may affect credit allocation by lending source, and estimates of interfirm credit extended by SOEs that are reported on a regular basis to the Ministry of Finance.

### 2.1.2 Interest Rate Channel

The interaction between domestic interest rates and the real exchange rate has powerful effects on output and employment. In an economy with underutilized resources, a stable and undervalued real exchange rate helps to maintain a low interest rate environment<sup>24</sup>, and the combined effect of these two key macro prices (competitive real exchange rate and low interest rate) should strongly support rapid output and employment growth if there are no significant bottlenecks on the supply side. Low interest rates stimulate domestic demand by encouraging private investment, investment in higher education, and spending on consumer durables. On the supply side, growth of the capital stock (including human capital stock) through higher net investment supports expansion of the economy's productive capacity and increases labor productivity.

The link between the short-term interest rate controlled by the SBV and the commercial bank lending rate is straightforward, and has direct impact on the activities of enterprises, particularly SOEs, that borrow in the formal financial sector. The link between the SBV controlled short-term interest rate and the unobserved lending rate in the informal financial sector is less clear. Under conditions of credit market segmentation, financial repression, and credit rationing, the impact of changes in the interest rate on aggregate demand necessarily follows a circuitous route.

Firms that have access to the formal banking system can operate as financial intermediaries to credit constrained firms by providing the latter with trade credit. In other words, they play a role in credit creation through the informal financial market. Thus, interfirm credit in Vietnam may be considered an imperfect substitute for bank credit. Nonbank firms that function as intermediaries would be expected to charge an implicit markup on the interest rate that they are charged by the bank, and this markup may take the form of covert price discrimination (McMillan and Woodruff 1999). A tightening of monetary policy, either through the imposition of bank-by-bank credit ceilings and/or increase in bank lending rates, will increase the borrowing costs of firms

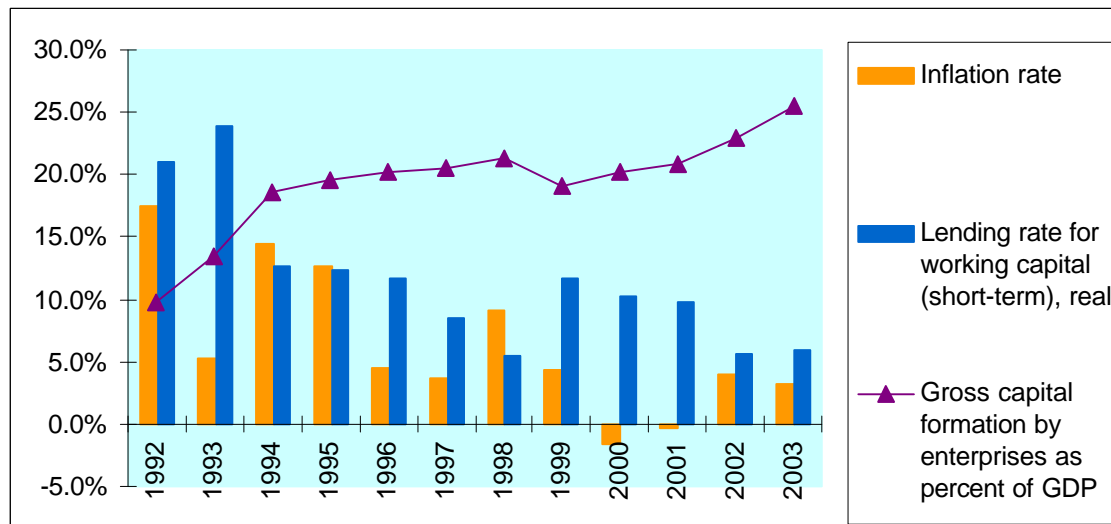
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<sup>24</sup> The theory of uncovered interest parity (UIP) – that foreign interest income expressed in the domestic currency should equal the domestic interest rate – suggests a strong link between low domestic interest rates and a weak (or competitive) exchange rate.

that receive bank credit. Their higher borrowing costs are then passed on to credit constrained firms, squeezing the latter's ability to raise sufficient working capital to finance their operations, with predictably negative effects on firm output, profitability, and investment spending.

The gradual decline in the share of public investment in gross capital formation<sup>25</sup>, and corresponding rise in the share of enterprise (and household) investment, suggests that interest rate movements are gradually having a stronger impact on the real economy<sup>26</sup>. This change in the composition of investment spending also indicates that a gradual flattening of the IS curve has been taking place during the period of structural transformation. The evolution of enterprise gross capital formation as a share of GDP, the inflation-adjusted lending rate (short-term) for working capital, and the inflation rate from 1992 to 2003 is presented in Figure 7. The savings-investment gap has narrowed considerably as domestic investment as a percent of GDP is following more closely the trend rise in gross national savings as a percent of GDP. Gross domestic investment as a percent of GDP rose from 24.3 percent in 1993 to an estimated 35.1 percent in 2003,

Figure 7. Gross capital formation by enterprises, inflation & real lending rates: 1992-2003



Source: Author's calculations based on IMF, SBV and GSO data.

<sup>25</sup> Public investment tends to be an exogenous component of investment spending that is not so sensitive to interest rate movements.

<sup>26</sup> This adds support to the rationale for introducing time-varying coefficients in the analysis of adjustment mechanisms.

while gross national savings as a percent of GDP rose from 12.2 percent to 32.6 percent over the same period (World Bank 2004).

The graphical presentation of the data conveys the impression that during the early reform years, institutional and structural factors played an even more important a role than macroeconomic prices such as inflation and interest rates in determining enterprise fixed asset investment as a share of GDP. Despite high real lending rates in 1992 and 1993, enterprise gross capital formation rose sharply from a very low base in response to a more favorable business environment associated with market-oriented reforms and stabilization of the macroeconomy. From 1995 to 1998, the increase in enterprise investment as a share of GDP rose more slowly (finally dipping in 1999<sup>27</sup> due to the effects of the Asian financial crisis), despite a decline in real lending rates during that period. From 1999 on, gross capital formation by enterprises as a share of GDP has risen more rapidly as real lending rates have declined (in other words, both variables are now moving in the right direction relative to each other).

More research is needed to examine the hypothesis that the transmission lag of interest rate movements on the real economy may be longer than previously thought<sup>28</sup>. One reason for the longer lag is that the main source of financing for gross capital formation by nonstate enterprises is retained earnings (due to credit constraints and the undeveloped state of financial markets), which is a function of enterprise profitability and the firm's growth prospects, and therefore indirectly a function of aggregate demand.

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<sup>27</sup> I estimate that enterprise gross capital formation may have fallen by about 6.6 percent in real terms in 1999. There are no official estimates of enterprise investment (defined as the sum of investment by state, non-state and foreign invested enterprises). The GSO estimates total gross capital formation without disaggregating public spending on infrastructure from investment spending by business enterprises. My preliminary and very approximate estimate of enterprise investment is derived from subtracting state capital expenditure from gross capital formation (all in nominal terms), and assuming that its share of nominal GDP would be the same as its share of real GDP (in other words, I do not account for changes in relative prices that may affect share estimates). This approach has important limitations because private investment is likely to be underestimated by the government, which means that total gross capital formation may be underestimated. The reason: private enterprises have a strong incentive to avoid disclosing information about their activities to officials to reduce their tax exposure and to avoid the attention of rent-seeking officials (Packard and Thurman 1996).

<sup>28</sup> For this reason, lagged variables should be introduced in analyzing the relationship between interest rate movements and real variables. According to the IMF, the SBV considers the transmission mechanism of interest rates on inflation to be weak and slow because its indirect instruments are not very effective due to the highly segmented and illiquid government securities market (IMF 2004).

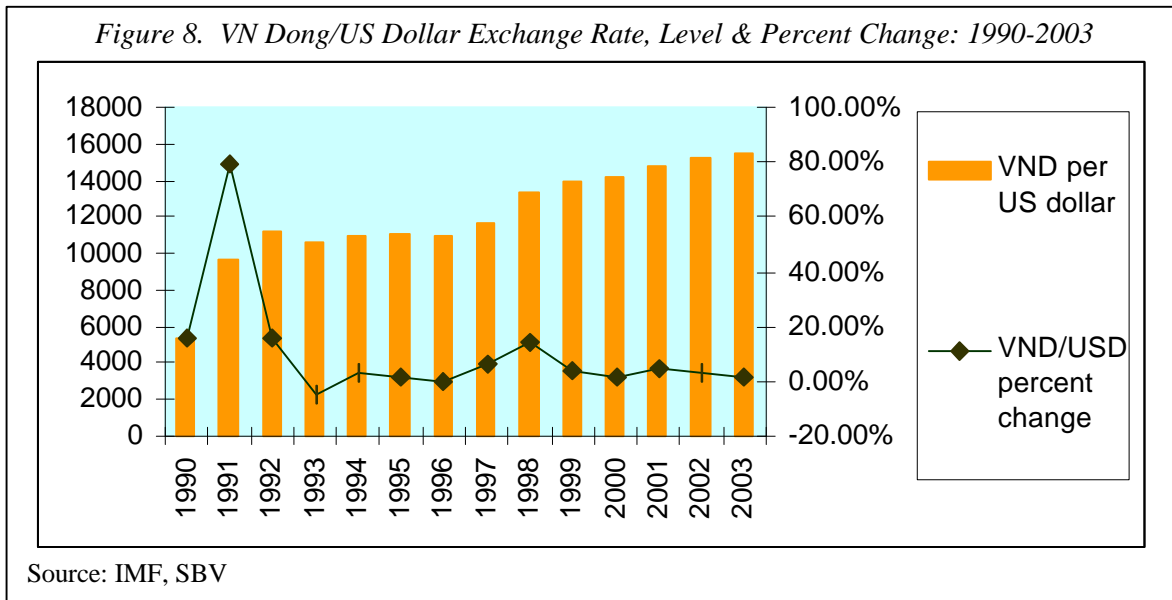


The inelasticity of nominal dong interest rates (see Section 1.2) is a puzzle since the SBV has liberalized interest rates. Other political forces may be at work to pressure the SOCBs to keep rates at concessional levels. The narrow spread between deposit and lending rates is hurting their profitability.

### 2.1.3 Exchange Rate Channel and Determinants of Net Foreign Assets

A stable and competitive real exchange rate (RER) not only helps to maintain low interest rates, but it also affects key relative prices (between tradable and nontradable goods, capital goods and labor, and indirectly on exports and imports through intermediate input and capital goods costs). These are the primary channels for the RER to influence aggregate demand and resource allocation (Frenkel and Taylor 2005).

The full impact of the central bank's exchange rate policy<sup>29</sup> on the real economy is not easily determined because we do not know how the growth of monetary aggregates are actually affected by Vietnam's informally pegged exchange rate regime. The SBV does not provide information on its interventions in the foreign exchange market<sup>30</sup> and there is no explicit sterilization policy. An examination of the detrended growth path<sup>31</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. This absence of systematic sterilization does not appear to have a negative impact on monetary aggregates as the growth rate of M2 has not been overly volatile and inflation has been under control. As shown in Figure 8, the SBV was successful in maintaining the VN dong's stable relationship to the US dollar, no negative pressure on the stock of international reserves was detected, and financial deepening



<sup>31</sup> Quarterly data, not seasonally adjusted.

expanded rapidly from 1999 on (see Figure 12), 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 did not appear to have predictive power regarding 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 money supply was passive (endogenous) during that period. However, the interbank exchange rate was found to contain significant advance information on the evolution of output. For this reason, an important monetary variable that is likely to influence inflation and output growth may be net foreign assets, which should be included in the VAR analysis.

The evolution of net foreign assets as a percent of total liquidity<sup>32</sup> and the annual growth rate of credit to the economy<sup>33</sup> is presented in Figure 6 (measured on right axis), while the left axis tracks the inflation rate and real GDP growth rate. The graphical presentation of the real and nominal effective exchange rate as calculated by the IMF also is included to provide information on the influence of a key macro price variable. 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.

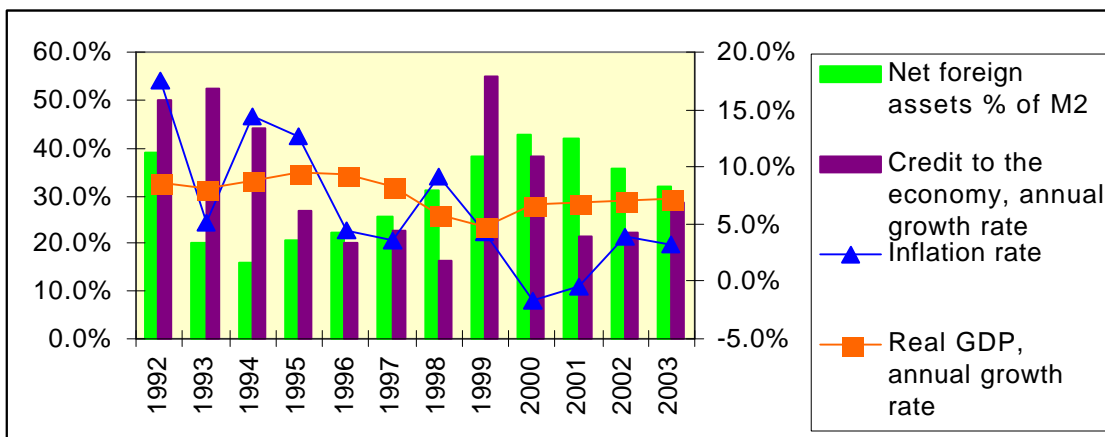
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<sup>32</sup> Total liquidity is M2, defined as the sum of net foreign assets and net domestic assets.

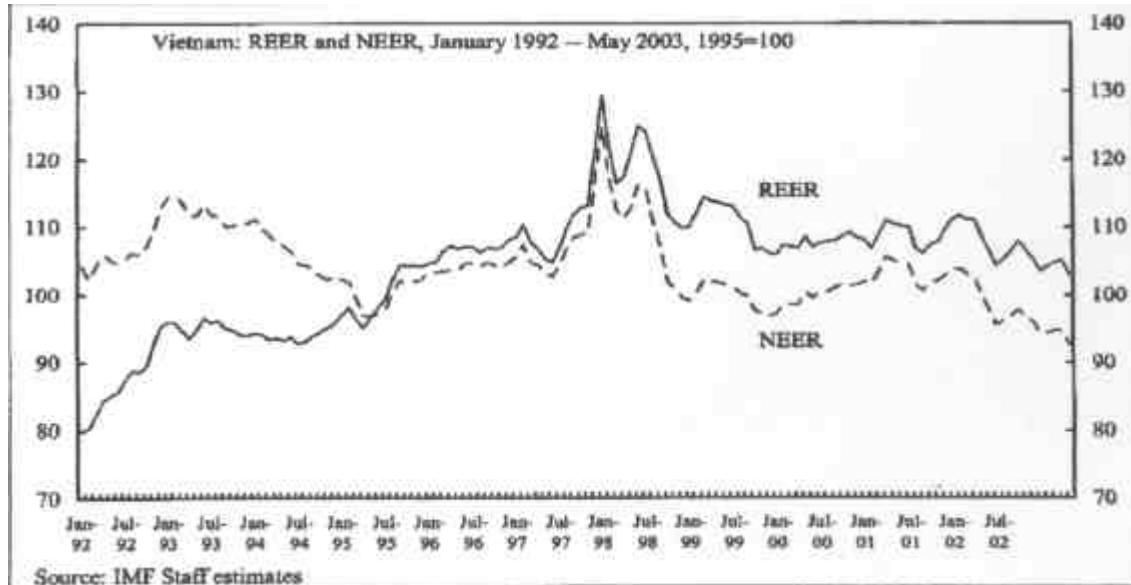
<sup>33</sup> The authors of the CIEM study noted that monthly observations of credit growth were not available to include in the VAR models.

The trend appreciation of the nominal effective exchange rate from 1995 to early 1998 overlaps with the rising share of net foreign assets as a percent of total liquidity (from 1994 to 2000). This change in the relative price of tradables to nontradables caused a slowing of export growth, made imports more attractive, and brought down the GDP growth rate<sup>34</sup> as well as credit growth. The combined effect of exchange rate appreciation and slower GDP growth rate helped to bring down the inflation rate, which stood at over 12 percent in 1995 and fell to a deflationary -1.6 percent in 2000 and -0.4 percent in 2001.

Figure 9. Evolution of Net Foreign Assets, Credit to the Economy, Inflation and GDP.



Source: Author's calculations based on data from the IMF and SBV.



<sup>34</sup> The contractionary effects of the 1997-98 Asian financial crisis on Vietnam's exports and foreign direct investment (FDI) also should be noted.

From 2000 on, the composition of total liquidity changed due largely to changes in the balance sheets of deposit money banks (DMBs). The growth of net domestic assets (mainly domestic credit) significantly outpaced the growth of net foreign assets. A breakdown of the composition of net foreign assets indicates that the SBV's net foreign assets have continued to increase sharply, but this has been offset by steep declines in net foreign assets held by the DMBs. The reason for this shift: the DMBs have repatriated foreign currency assets previously held in offshore financial institutions in response to the positive spread between the rate offered by the SBV and international interest rates which currently offer very low yields (IMF 2004).

The decomposition of liquidity is presented in Figure 9. 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>35</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.

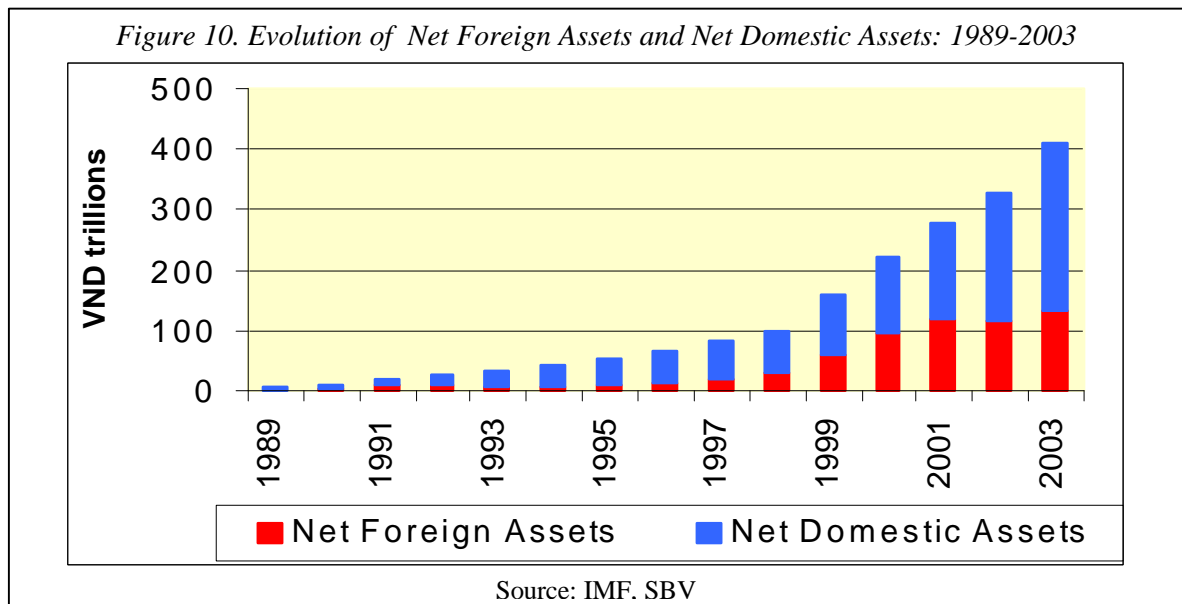
Similar to other developing countries, remittance inflows have become a primary source of foreign currency earnings for Vietnam. According to a deputy governor of the SBV<sup>36</sup>, remittances have risen dramatically, from USD 35 million in 1991 to USD 2.3 billion in 2003 (to put this amount in perspective, it is somewhat less than the 2003 trade balance deficit of USD 2.5 billion, and represent about 11.5 percent of total merchandise exports). He estimated that it jumped to USD 3.2 billion in 2004, with Ho Chi Minh City receiving over half (nearly USD 1.85 billion). There are two different estimates for gross FDI inflows in 2003: the MPI estimate is USD 2.667 billion, and the IMF estimate (based on foreign equity inflows plus foreign borrowings by joint ventures reported by the SBV)

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<sup>35</sup> Remittances are sent by ethnic Vietnamese living abroad and by Vietnamese migrant workers whose foreign stay is mainly 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. More research is needed to assess the gender breakdown of migrant workers and possible gender aspects of remittance inflows.

<sup>36</sup> Deputy Governor Tran Minh Tuan's estimates were reported in Vietnam News, January 21, 2005 (Source: [http://www.vneconomy.com.vn/eng/article\\_to\\_print.php?id=050121141012](http://www.vneconomy.com.vn/eng/article_to_print.php?id=050121141012)).

is USD 1.829 billion (IMF 2004a). Net official transfers in 2003 are estimated at USD 139 million and ODA loans at USD 1.258 billion.



Worker remittances depends on the number of migrant workers, which in turn is determined by government policies, human capital development involving specific labor skills, and economic conditions in host countries. Remittances by overseas Vietnamese are influenced by international perceptions of political conditions in Vietnam, the number of overseas Vietnamese visiting their homeland<sup>37</sup>, state policies on remittances from overseas Vietnamese<sup>38</sup> and their other economic activities in Vietnam, and regulations governing money transfers from abroad<sup>39</sup>. How much of the remittance money is held in

<sup>37</sup> It is widely assumed that there is a strong correlation between the number of overseas Vietnamese visitors to Vietnam and estimates of remittances from overseas Vietnamese. Thus, the authorities estimated that some 203,660 overseas Vietnamese returned to their homeland during the first 6 months of 2004, representing a 43 percent increase over the previous year. Banking experts in Vietnam estimate that overseas remittances increased from USD 2.6 billion in 2003 to USD 3.8 billion in 2004 (note that these estimates are higher than the SBV's estimates).

<sup>38</sup> According to Pham Van Tan, Chairman of the East Asia Overseas Remittance Company Executive Board of the East Asia Commercial Joint Stock Bank, the government's remittance-friendly policies created a competitive environment between banks on the provision of remittance-related services, and led to an increase in the transfer of funds via personal accounts.

<sup>39</sup> Government policy affects the flow of remittances through the formal banking sector. This was seen in late 1996 when the government imposed a 5 percent withholding tax on remittances. The remittance inflow switched to informal channels and flows through the formal banking sector fell sharply. It only rose again after the government rescinded the tax in February 1997 (Haughton).

the formal banking system, and how much in the informal financial sector or under mattresses, depends in part on expectations regarding the stability of the VND/USD exchange rate and the spread between the bank forex and parallel market rate, and in part on the state of financial sector development. The impact of the remittances on the real economy flows through two channels: household spending on real estate, durables, and non-durables, and enterprise spending on working capital and fixed assets. Thus, remittances are believed to be an important source of financing that is helping to fuel the growth of private investment. More research is needed to quantify this to gauge its significance as a driver of domestic private investment.

Figure 11. FDI Disbursements & Investment by Ownership Sector: 1995-2003

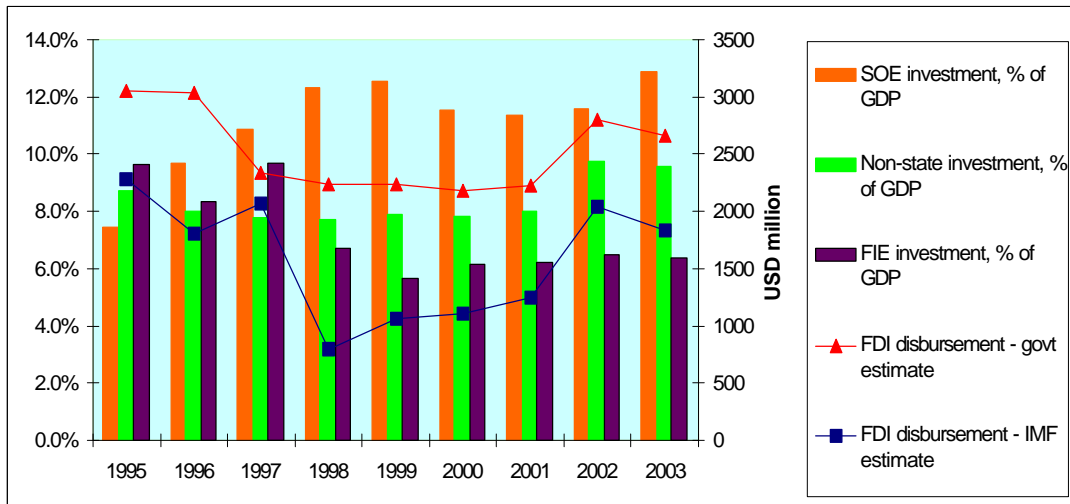
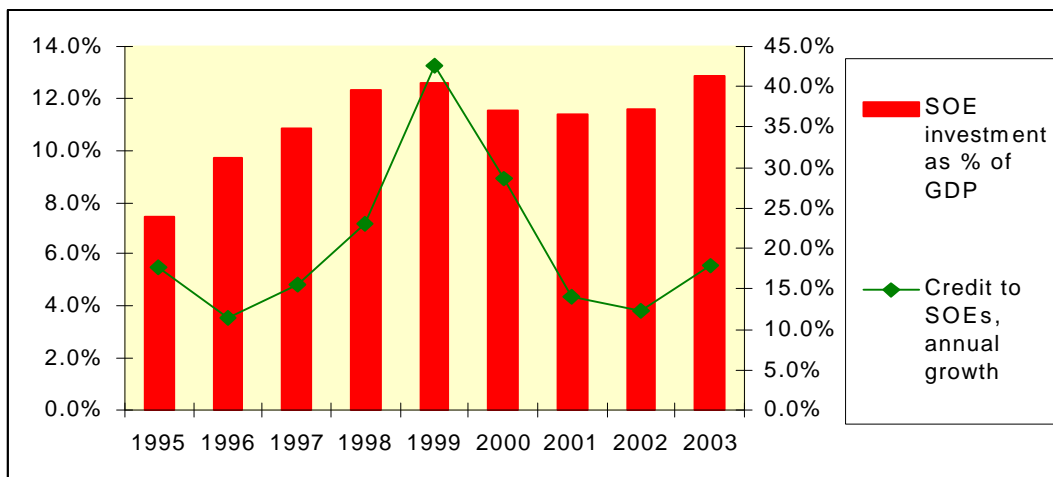


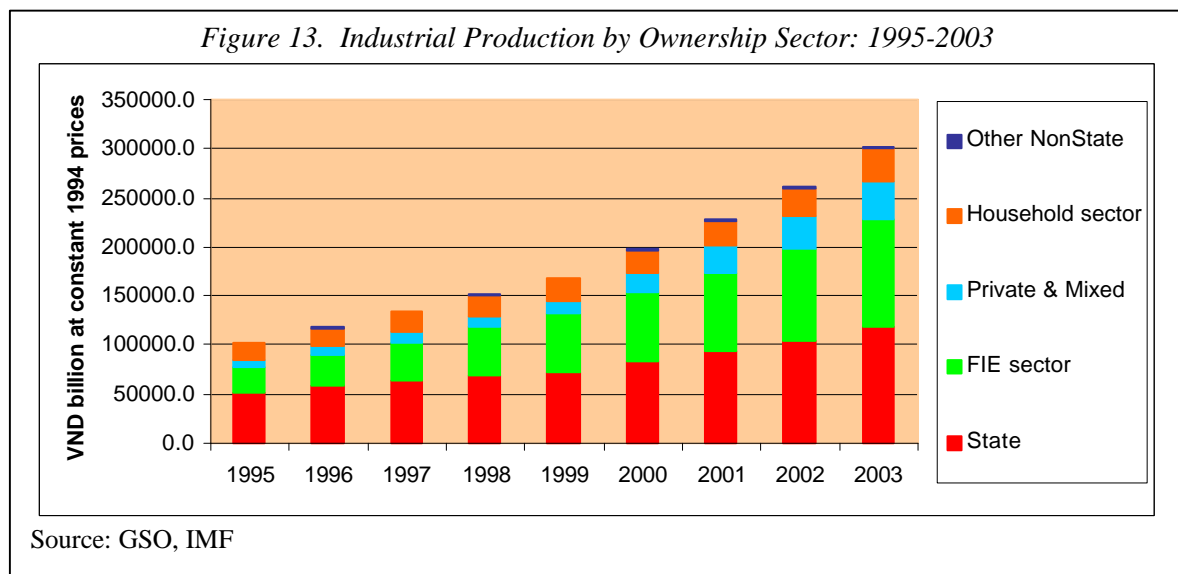
Figure 12. SOE Investment and Growth of Credit to SOEs: 1995-2003



Source: IMF, SBV

The impact of FDI flows on real variables is easier to track and quantify. Figure 11 compares government and IMF estimates of FDI disbursement from 1995 to 2003 and changes in the composition of investment as a percent of GDP (current prices). Noteworthy changes in the composition of investment by ownership sector: the FDI sector's investment share was greater than that of the SOE and domestic nonstate sector in 1995. Since then, the share of investment by SOEs increased more rapidly and represented 12.9 percent of GDP in 2003. However, there is no clear link with bank credit allocated to SOEs (see Figure 12). More research is needed to determine the main sources of finance for SOE investment in fixed capital, and the role of retained earnings in SOE investment spending. Correlated with the estimated rise in remittance inflows, the share of domestic nonstate investment also rose to 9.6 percent of GDP in 2003<sup>40</sup>. In contrast, the FDI sector's share declined to 6.4 percent, weakly reflecting the pattern of FDI disbursement during this period.

The disaggregation of industrial production by ownership sector is presented in Figure 13. Although the FIE sector's share of total investment was shrinking, its share of total industrial production rose from 25.1 percent in 1995 to 36 percent in 2003, reflecting the accumulation of past investment spending and experience operating in Vietnam's transition economy. The nonstate sector's share has followed a broad U

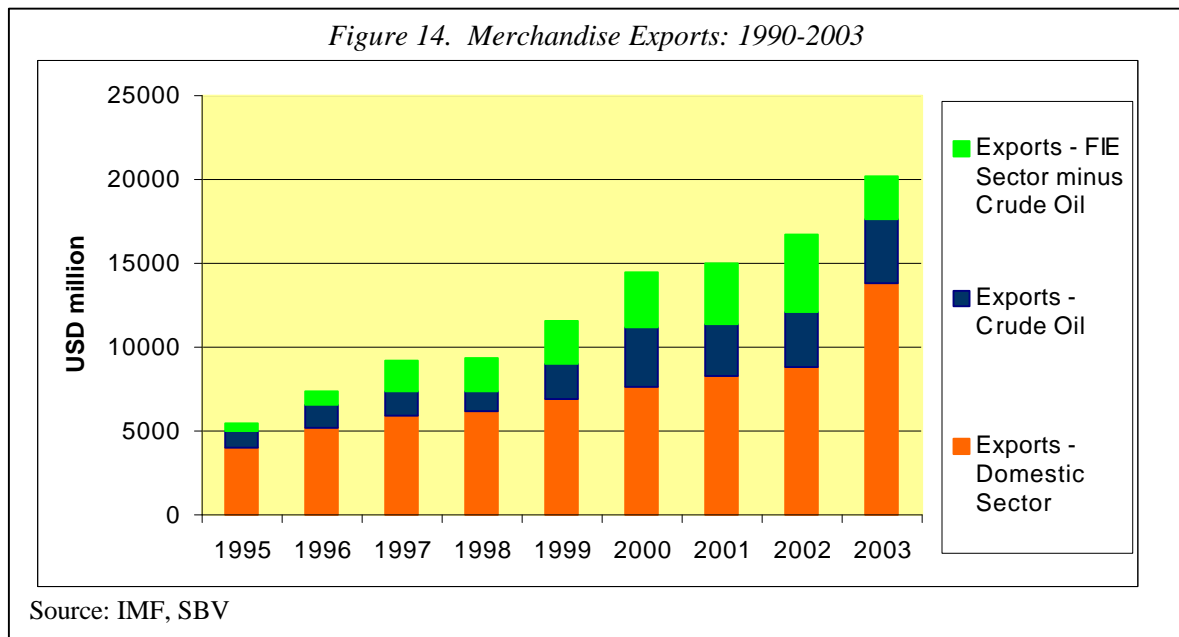


<sup>40</sup> Clearly, more research is needed to analyze and track the links between remittance inflows and domestic nonstate investment.



curve: it declined from 24.6 percent in 1995 to 21.8 percent in 1999, and then rose again. More favorable state policies towards the domestic private sector, particularly towards private enterprises, is probably an important factor in the rise in its share of industrial output, which reached 24.9 percent in 2003. The rising share of the private and mixed enterprise sector from 6.4 percent of total industrial production in 1995 to 12.7 percent in 2003, and the declining share of the household sector from 17.6 percent to 11.6 percent during the same period, reflects state policies that govern the business climate. In contrast, the state sector's share fell from 50.3 percent in 1995 to 39.1 percent in 2003, which is somewhat surprising in light of the strength of SOE investment spending. More research is needed to determine if this indicates the declining productivity of SOE investment.

The disaggregation of merchandise exports by type of ownership and the contribution of crude oil exports to Vietnam's foreign exchange earnings is presented in Figure 14. Exports from the domestic economic sector increased sharply in 2003, indicating that domestic exporters have become more competitive in international markets. Surprisingly, exports (excluding oil) from the foreign invested sector fell from its peak level of USD 4.6 billion in 2002 to USD 2.5 billion in 2003.



## ***2.2 Employment and Labor Market Structure***

Similar to other developing countries, the main segments of Vietnam's labor market are the agricultural and rural sector, the informal urban sector, and the formal urban sector. The agricultural and/or rural workforce mainly consists of household enterprises, self-employed and unpaid family workers. It is characterized by a seasonal pattern of employment. The informal urban sector is largely made up of self-employed workers and small enterprises. Its main outputs are services and other nontradables. Workers in this sector have little bargaining power, and have no formal employment contract. The main characteristics of the agricultural/rural and informal urban sectors are lack of job security and flexible wages, because legal minimum wage laws are not enforced in these sectors. In contrast, the formal urban sector is made up of medium and large enterprises including state enterprises. Workers have formal contracts, and both workers and employers are subject to labor market regulations including minimum wage laws.

At the present time there are no official estimates of the size of these main components of the labor market. However it is generally assumed that there is considerable overlap between the agricultural and/or rural workforce and workers in the agricultural sector, and between the workforce in the formal urban sector and workers in the industry and construction sector, and that large numbers of workers in the services sector form part of the informal urban sector. According to estimates prepared by the Vietnam Ministry of Labor, Invalids and Social Affairs (2004), as of 2003 about 23.1 million people worked in the agriculture, forestry and aquaculture sectors, 6.7 million people worked in the industry and construction sectors, and 9.8 million people worked in the services sector.

The rapid increase in Vietnam's per capita GDP growth rate during the 1990s is linked to the trend shift in the country's employment structure away from the low productivity/ low wage agriculture sector towards the higher productivity/higher wage industry, construction and services sectors. In 1996 nearly 69 percent of the labor force worked in agriculture, but the share has declined to 58.4 percent in 2003. At the same time, the share of the labor force in the industry and construction sector has risen from

10.9 percent in 1996 to nearly 17 percent in 2003. The share of labor in the services sector also has risen from 20.2 percent to 24.7 percent during the same period. The monetary authorities can encourage a continuation of this employment shift towards labor-using higher productivity sectors of the economy by maintaining a mix of macroeconomic relative prices consistent with a stable and competitive real exchange rate (RER). This would strengthen profitability in these sectors which in turn would stimulate further employment growth.

An important source of reliable information on developments in Vietnam's labor market comes from the Vietnam Living Standard Surveys (VLSS) conducted at five year intervals by the General Statistical Office (GSO). These surveys show that a significant expansion of the formal sector has taken place, particularly during the period from 1998 to 2002, as measured by the rising share of the population (age 15 years and older) whose main source of income is from nonfarm wage employment. As indicated in Table 1 and Figure 15, the primary gains in non-farm wage employment took place in rural areas from 1998 to 2002, indicating that significant progress was made in rural development.

*Table 1. Main Household Income Source from Nonfarm Wage Employment*

	1993	1998	2002
National	9.55	11.78	22.29
Urban	32.73	36.89	47.50
Rural	4.23	5.06	15.16
Male	N.A.	14.46	27.84
Female	N.A.	9.27	16.84
Quintile 1	4.85	5.28	5.10
Quintile 2	5.23	6.20	12.18
Quintile 3	6.00	7.99	19.28
Quintile 4	10.23	11.40	28.28
Quintile 5	20.57	27.49	43.80

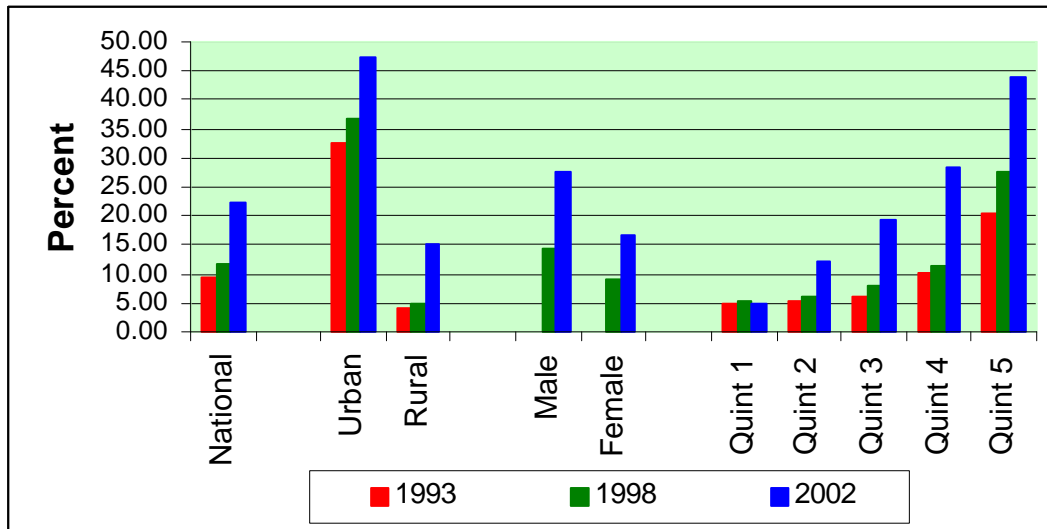
Source: GSO VLSS 1993, VLSS 1998, VLSS 2002

However, the poorest households (Expenditure Quintile 1) were largely excluded from participating in the expansion of the formal sector. Only 5.1 percent of households in this expenditure category had as their main income source earnings from non-farm wages, compared to 43.8 percent of the richest households (Expenditure Quintile 5).

It is also noteworthy that between 1998 and 2002, household groups in the middle expenditure quintiles experienced very rapid increases in nonfarm wage employment. While the percent share of nonfarm wage employment have increased for both men and women, the

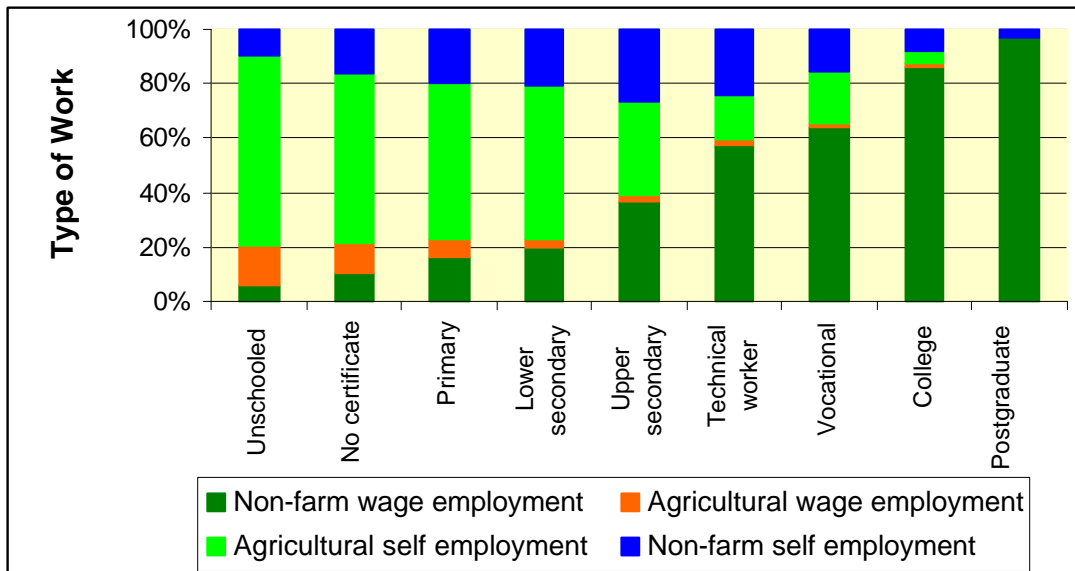
gender gap remains pronounced: 27.8 percent of all men are nonfarm wage earners while only 16.8 percent of all women are nonfarm wage earners. There also is a high correlation between educational level and type of work. This is presented in Figure 16.

Figure 15. Nonfarm Wage Employment: Share of Total Employment



Source: GSO VLSS 1993, VLSS 1998, VLSS 2002

Figure 16. Employment Distribution by Education Level and Type of Work in 2002



Source: GSO VLSS 2002

### 3 Macroeconomics and Central Bank Institutional Framework

#### 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 did come to Vietnam to conduct seminars on IT for SBV senior management<sup>41</sup>, the consensus view holds 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.

According to 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, the inflation target does not have priority over other development objectives such as rapid and sustainable growth, and it is unlikely that the government would be willing to commit to subordinating exchange rate or employment objectives to the inflation target. At the same time, it is understood by the political leadership that keeping inflation under control is a precondition for sustainable growth. The lesson they have drawn from Vietnam's experience over the past 20 years is that the stability of key macro prices (inflation rate, exchange rate, and interest rates) was necessary to support the very high economic growth rate that was achieved (see Figure 6). For this reason, the authorities consciously adopted prudent macroeconomic policies to ensure the stability of key macro prices during the *Doi Moi* period.

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<sup>41</sup> Among them: Hans Genberg, Edwin Truman,

In the view of various Vietnam specialists, the country's present stage of development makes it difficult for the authorities to cleave to the injunction against allowing fiscal priorities to dominate monetary policy because the government has limited means to raise revenues. Because financial markets are thin and not well developed (the government securities market is segmented and illiquid), the SBV has difficulty implementing monetary policy using market-based indirect instruments to influence inflation, even though this has long been a declared SBV objective. In addition, as explained in Sections 1.1 and 2.1, the government is only beginning to build the necessary foundations (including timely access to a high frequency databank of key economic and financial variables that are essential for policy analysis) for developing a "reasonable understanding of the links between the stance of policy and inflation". As regards the adequacy of policy instruments, it is doubtful that the coordination of fiscal and public debt management activities would have the primary goal of supporting the inflation target above all other national development goals. It is also unlikely that the government would be willing to subordinate fiscal policy to meet the inflation objective, especially if the targeted inflation rate results in economic contraction.

[Subsection: organizing focus of SBV monetary policy]

Reaction function of the SBV explored:

Chart comparing actual interest rates in VN with nominal short-term interest rate  $i_t$  specified under original Taylor rule:

$$i_t = \bar{\delta}_t + r^* + 0.5 (\bar{\delta}_t - \bar{\delta}^*) + 0.5(y_t)$$

where:

$r^*$  is "natural" real interest rate that is consistent with Vietnam's socio-economic targets.

$\bar{\delta}_t - \bar{\delta}^*$  is 4-quarter moving average of actual inflation in GDP deflator less a target rate.

$\bar{\delta}^*$  is target rate set by National Assembly.

$y_t$  is percent deviation of real GDP from an estimate of its potential level.

Issues regarding GDP gap in VN problematic: notion of full employment or full capacity GDP may be feasible for formal sector (we can start with Cobb-Douglas type production function) but for informal sector Lewis type model with unlimited supplies of labor may be more appropriate.

IMF estimate of potential GDP in VN relies on ad-hoc application of Hodrick-Prescott filter to annual GDP data in constant 1994 prices over period 1988-98. Estimated current growth rate of potential GDP is sensitive to endpoints of data series & hence is given as a range (IMF 1999 p. 7). Use of Hodrick-Prescott filter may not be appropriate for estimating VN's potential GDP because of implicit assumption that the nonstationary time trend extracted from observed GDP is a good proxy for potential GDP.

What is the right inflation measure to use and what components of inflation should be most closely watched?

SBV formulation of monetary policy:

Is there a case for lengthening the time horizon over which SBV tries to achieve its inflation target (because targeting inflation over too short a horizon may result in high output losses)? Does SBV target inflation over medium term? Is there a target band?

Does SBV monetary policy give equal weight to inflation and output variability? Should weight also be given to issue of variability of the real exchange rate? Is there a tradeoff between inflation variability and output variability?

Discussion of chart on variability of inflation rate, real interest rate, real exchange rate, industrial production, and other measures of real output.

SBV exchange policy: how much importance is given to policies to lower risk of high exchange rate volatility? According to Calvo and Reinhart (2001), pass-through effect of high exchange rate volatility to domestic prices can destabilize financial sector.

SBV plan to phase out dollarization: SBV understands risks of dollarization and in low-key fashion has been implementing plan to gradually phase it out.

Formulation of SBV monetary policy to take into account external supply shocks and significant changes in international exchange rates and interest rates: impact of cross exchange rate movements on Vietnam's tradables sector (including possible revaluation of Chinese yuan), long term movements in key US dollar cross rates, rising world interest rates, etc. Assessment of financial soundness indicators: non-performing loans, capital ratios, exposure to exchange rate or interest rate risks.

### ***3.2 Identification of Linkages Between Macro Prices***

#### IMF analysis of inflation dynamics in Vietnam

- Food & foodstuffs account for 48 percent of CPI basket
- Trajectory of food prices different from nonfood prices
- Use of nonfood price as proxy for “core” inflation?
- Oil prices affect CPI mainly through transportation, housing and construction materials costs
- Significant degree of persistence due to sluggish adjustment of inflationary expectations
- Seven-variable recursive VAR approach to enable identification of shocks from external and policy developments; structural shocks recovered from VAR residuals using Cholesky decomposition of variance-covariance matrix. The seven variables are: international oil prices, international rice prices, industrial production, exchange rate, monetary or credit conditions, import prices, consumer prices.
- 4 key sources of inflation identified (Loungani and Swagel 2001)
  - Underlying fiscal imbalances → excessive money creation or exchange rate depreciation associated with balance of payments crisis
  - Macroeconomic overheating
  - Supply-side cost shocks
  - Inertial component due to sluggish adjustment of inflationary expectations
- Data: monthly CPI; monthly industrial production index available from 1995
- VAR estimated from January 1995 to March 2003 in log differences with 3 lags; variance decompositions computed next; assumption: causality runs from external shocks to output, exchange rate, to money and prices, with degree of endogeneity increasing. Recursive structure precludes feedback of prices to exchange rates and monetary policy within one time period. Alternative measures of nominal exchange rate (bilateral versus nominal effective), monetary conditions (reserve money and broad money), and consumer prices (headline and core inflation).
- Own innovations play large role in variation of import prices, but international oil prices and exchange rate changes account for nearly 30 percent of variation each; oil price and exchange rate shocks show a complete exchange rate pass-through to import prices within a few periods but have a modest exchange rate pass-through to consumer prices. A one percent shock to exchange rate → quarter percent change in headline inflation within a year with very little further pass-through in subsequent periods (this is in mid-to-lower range of previous studies for developing countries). This modest pass-through may be due to imperfect competition, low weight of importables in consumption basket and distribution costs which comprise large share of nontraded inputs; institutional factors such as administered prices and state trading companies also reduce impact of exchange rate changes.
- More consumer-oriented retail price index less influenced by changes in exchange rate due to large weight on non-tradeables in CPI.



- Core inflation susceptible to oil price shocks and exchange rate changes; broad money growth has modest impact on both core inflation and headline inflation; own innovations to core inflation seem more persistent than headline inflation.
- Role of monetary aggregates on CPI not robust or significant providing little guide to monetary policy. No cointegrating relationship was found between monetary aggregates and CPI over sample period.

## 4 Investigating Alternatives to Inflation Targeting

### 4.1 Identifying Alternatives in Terms of “Real” Targets

Monetary policy should be consistent with and support Vietnam’s national priorities in order to create good jobs for growing labor force (1.2 million new entrants per year). As noted in Section 1.1, the priorities are: rapid and sustainable growth, modernization, industrialization, and poverty reduction. Virtuous circle: strong economy characterized by balanced and sustainable growth creates the necessary conditions that strengthen the effectiveness of monetary policy instruments, which in turn supports further economic growth and development.

Detailed articulation of national development strategy (more meat, less vagueness) need to be laid out in order to determine what should be the (realistic) contribution of monetary policy and to identify appropriate real targets. In other words, monetary policy should have firm roots in Vietnam’s development strategy and it should be formulated in rigorous fashion (this also is needed to anchor the national development strategy in reality). To support this process, it would be useful to employ several different models of the Vietnamese economy (structuralist, structural macroeconomic, CGE, single-index models of coincident economic indicators using cointegration techniques along the lines described by Stock and Watson). This would enable us to consider several versions of the Vietnamese economic story, the different assumptions underlying each version, and the different outcomes they produce. A well articulated economic system would help policymakers visualize how the growth process is made possible, what policy changes are needed to create conditions for sustained high growth rates, how this can be achieved, and the key indicators that should be monitored to gauge progress (Packard and Thurman 1996). This exercise includes identifying what should be the SBV’s real targets.

Example of possible indicators to monitor progress in meeting development goals:

- Proportion of wage earners in total employment (proxy to estimate size of modern sector in Vietnam)
- Share of medium-to-large enterprise sector in gross industrial output
- Share of non-state sector formal employment in total employment
- Growth rate of wage employment

Promising avenue to investigate: how can monetary policy be used to support non-inflationary strategies to accelerate economic development and increase incomes of poor households?

Strategies and implications for monetary policy:

- Strategy to address problem of the “missing middle” (UNIDO 2004): development of medium-to-large enterprise sector is critical to jump-start industrialization process in Vietnam (this is an example of describing a specific development plan to help

policymakers visualize the growth process in concrete terms). Issue: 95 percent of industrial enterprises in Vietnam fall in the small and medium category. Highly skewed “Gini-like” distribution where smallest 50 percent of firms create about 5 percent of total enterprise employment, absorb about 3 percent of total capital in enterprise sector, and generate less than 1 percent of total profits. Development of medium-to-large enterprise sector will accelerate formalization of the economy, human capital development, technological development, development of management skills, and contribute to strengthening the competitiveness of domestic firms. To lay the foundations for sustainable growth, strategies that give priority to developing the medium-to-large enterprise sector may be more effective than strategies that advocate concentrating resources on developing the SME sector because mid-size enterprises have better capacity for learning and technological innovation and can create more jobs faster. Scarcity of medium-to-large enterprises has impeded financial sector development (essential for balanced growth of economy) because banking system is missing an important class of borrowers.

Figure 1. Distribution of enterprises and workers employed.

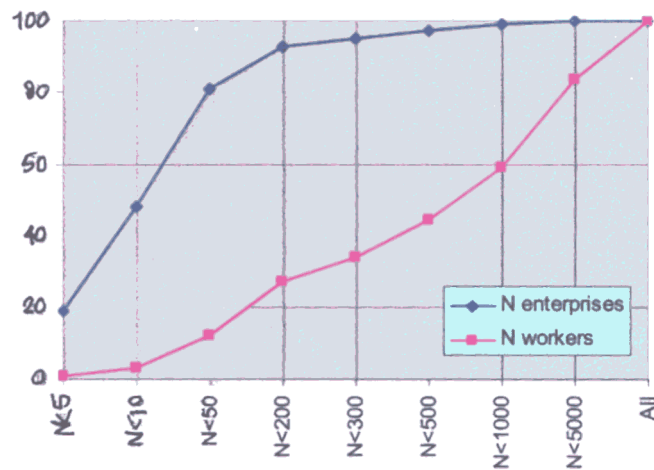
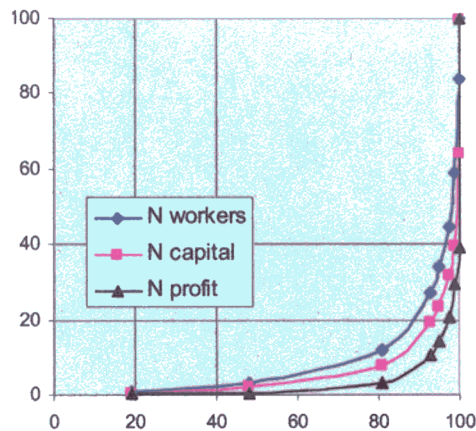


Figure 2. Enterprise employment, capital, and profits.



Source: UNIDO 2004

- Strategy to create incentives to expand formalization of the economy: To support this strategy, further development of banking sector is needed. Banking sector’s credit evaluation capacities need to be strengthened so banks can extend loans to creditworthy firms and encourage their migration to the formal sector. Other advantages: workers receive better treatment in formal sector than in informal sector; government’s tax revenue base is strengthened.

- Strategy to create conditions to support lowest possible domestic interest rates and improve solvency of domestic financial institutions.
- Strategy to help core industry sectors achieve critical mass: sectors where Vietnam has existing or potential comparative advantages include rubber, light manufacturing, seafood, food processing, information technology, chip manufacturing (low-end). In these promising sectors, upstream and downstream linkages need to be developed

Review of existing instruments of monetary policy and transmission links. Additional instruments to consider and its transmission links:

- Sustainable provision of banking services aimed at increasing income and output in priority sectors.

What should be stance of monetary policy in coming period of even more rapid international economic integration?

Possible negative scenario:

- Compliance with US-VN Bilateral Trade Agreement and WTO rules will increase pressure on import substitution industries and financial sector firms.
- Greater financial risk to banking sector from highly leveraged firms in import substitution and financial industries that suffer losses due to intensified competition.
- Sharp decline in tax payments by financially troubled SOEs increases risk that government's fiscal position will be weakened. Fiscal uncertainty associated with larger fiscal deficit and possible monetization of debt would increase inflation pressure (pass-through from debt monetization to inflation during 1985-98 period still a vivid nightmare for many Vietnamese).

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