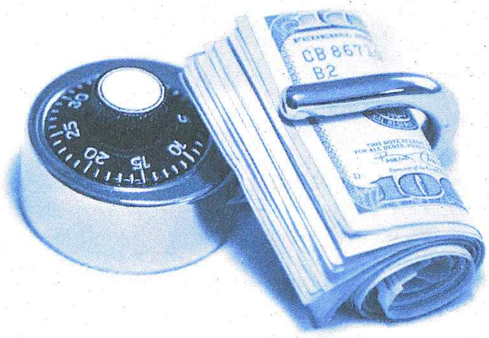
A DIRECTION FOR VIETNAM'S MONETARY POLICY DURING THE RECESSION



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As we know, the world economy is experiencing the most difficult period of the past decades when worldwide sudden changes and global crises affected badly each economy and the world as well. Vietnam couldn't be free from the global crisis and is facing great difficulties and challenges caused by the global recession and financial crisis. This situation reflects itself in falls in the GDP, and consumer price index, and rises in unemployment rate, and negative effects on other indicators.

In such a difficult situation, the monetary policy plays an important role in tasks of ensuring the employment, maintaining macro balances and stabilizing the domestic currency. This paper aims at estimating effectiveness of the Vietnam's monetary policy in the past few years, presenting some experiences of implementation of the monetary policies in some foreign countries, and suggesting some measures to improve the efficiency of the monetary policy.

Table 1: Key indicators of Vietnam's economic health 2005-2009

Indicator	2005	2006	2007	2008	2009E
GDP (% change previous year)	8.4	8.2	8.5	6.2	5.5
Unemployment rate (%)	5.3	4.8	4.6	4.7	5.5
Consumer price index (% change, period-end)	8.3	7.5	12.6	19.9	8
Government balance (% GDP)	-0.1	1.1	-2.2	-1.6	-4.0
Budget balance (%GDP)	-4.9	-5	-5.8	-6.8	-9.8
Trade balance (US$ million)	-4,531	-5,065	-14,12	-18,45	-17,04
Current account balance (US$ million)	-561	-229	-6,901	-9,135	-5,21
Current account deficit (%GDP)	0.4	0.5	-10	-12.3	-7.6
External debt (% GDP)	32.5	31.4	33.3	29.8	30.9
Reserves (US$ billion)	8.557	11.49	21	22.4	22.962
Domestic credit (% change, period-end)	31.17	25.4	53.9	21	20

Source: WB

1. Implementation of financial and monetary policies in 2001 – 2009

a. In the years 2001-2005, the world economy underwent a period of changing and unbalanced development due to such sea changes as record rises in the oil price, American double deficit, and falls in the US dollar value, etc. Vietnam was affected slightly by these changes and its government decided to increase the public expenditure and adopt a cheap money policy to recover the economy and encourage development of the private sector. The SBV cut the interest rate many times in 2001 to stimulate the credit growth. In 2002, however, the domestic market grew higher and signs of inflation made their appearance, which forced the Government to implement the monetary policy carefully to ensure the economic growth and control the inflation. The interest rate and exchange rate were managed flexibly based on changes in the market, which helped promote the production and export, thereby ensuring the socioeconomic development. Instruments of the monetary policy such as open market operations, required reserve, refunding, and exchange of foreign currencies were employed carefully to stabilize the money market. In 2003 in particular, the SBV for the first time allowed some commercial banks to offer option to their customers thereby helping companies reduce risks.

The years 2004 – 2005 were the last ones of the 5 –year plan but Vietnam had to face high inflation rates after a longtime struggling against the crisis. In addition, natural disasters also made the CPI and inflation rise strongly. This situation forced the Government use various instruments of the monetary policy to curb the inflation. In these years, the required reserve ratio was raised from 2% to 5% for deposits in the VND and from 4% to 8% for deposits in foreign currencies; the interest rate was set higher; the credit growth was lowered to 25% for 2004; and the exchange rate was kept stable. Required reserve, refunding and rediscounting were employed flexibly to implement the monetary policy effectively with the result that the growth rate in 2005 rose to 8.43% - the highest level in the 9-year period that helped Vietnam rank second among East Asian countries in terms of the economic growth, second only to China. The high growth rate in 2005 helped Vietnam achieve the average growth rate of 7.5% for the 5-year period (2001 – 2005).

Table 2: GDP and CPI in 2001 - 2005 (%)

Year	2001	2002	2003	2004	2005
GDP	6.84	7.04	7.24	7.69	8.43
CPI	0.8	4	3	9.5	8.4

Source: Statistics from the SBV and GSO

b. In 2006, Vietnam still faced the increased inflation rate and the Government had to follow the tight-money policy adopted in late 2005 to curb the inflation and facilitate the economic growth. In this year, the SBV kept stabilizing the base rate in order to avoid creating signs that might provoke increases in the interest rate, applied the same reserve ratio in order to reduce pressure on the deposit rate, and maintained a controlled floating exchange rate. And as a result, the total liquidity in 2006 rose only by 33.59% compared with a growth rate of 29.65% in 2005. The credit growth was lower but the loan quality was not enhanced. The export value rose by 22.2%, the GDP rose by 8.17% and the CPI growth fell to 6.6%.

In 2007, wide fluctuations took place on the world market, especially the American finance one when the credit crisis broke out and the record price of US$100 per barrel of oil. Meanwhile, the inflation rate in Vietnam kept rising. To deal with this situation, the SBV tightened the money supply employing various instruments of the monetary policy to curb the inflation and stabilize the macroeconomic conditions, such as expanding open market operations, increasing the required reserve ratio by 1.5 or two times, cutting increases in the total liquidity, and imposing a stricter control over the credit supply. To avoid negative effects on the economic growth, the SBV maintained the same base rate (8.25% per year), refunding rate (6.5%), rediscount rate (4.5%), overnight and deposit rates at the SBV; and removed rate-ceiling for deposits in the US dollar made by legal entities as from Jan 1, 2007.

In addition, the SBV issued Instructive 03/2007/CT-NHNN requiring commercial banks to control the credit growth strictly, limit loans supplied to investors in stock market to 3% of the total credit supplied, and beef up supervision of the supply of credit to such investors with a view to ensuring safety for the whole banking system.

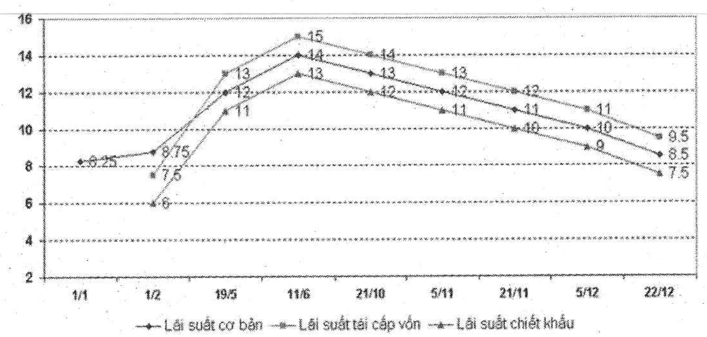
The credit growth in 2007, however, was very high. The credit supplied by the whole system rose by 53.89% over 2006. The SBV also injected some VND144,000 billion to the market to buy some US$9 million for its reserve, and increased the band around the official exchange rate, from ± 0.25% to ± 0.5% and ± 0.75%, thereby reducing the inflation pressure and allowing more autonomy for commercial banks. In 2007, as a result, the GDP grew by 8.48% while the inflation rate rose from 7.45% to 8.3%.

In 2008, the global crisis became more serious and Vietnam faced changes in opposite directions: a high inflation rate in the first half and recession in the second one, which caused difficulties for monetary policy making process. To curb the inflation, the SBV carried out a tight-money policy by limiting the ceiling of the lending rate on loans in the VND to 150% of the base rate; raising the required reserve ratio; changing the bidding procedures on the open market; and tightening the control over the stock and realty markets. These measures, however, led to shortage of cash, around VND40,300 billion within a short period of time, menacing effects on the banking system, and an interest rate war among commercial banks.

To avoid possible collapses, the SBV increased the money supply through the open market to provide banks with more cash. For example, it injected over VND39,000 billion to the market in the last week of February 2008. The exchange rate was made more flexible to stabilize the market. In the first half of 2008, the band around the exchange rate was adjusted three times and rose to ± 2% on June 27. This decision showed that the exchange control was loosened and it was appropriate to changes in market forces. In addition, the public expenditure and investment were cut and many unnecessary projects carried out by state-owned corporations were required to be postponed. All of these measures aimed at reducing the increased inflation rate.

Before domestic recession was solved, the American financial crisis and global recession broke out and affected seriously Vietnam in the second half of the year. The Government had to adopt a cheap-money policy to increase the total liquidity and encourage the supply of loans from banks. As from October 2008, main interest rates were cut continuously according to a reasonable process; the required reserve ratio was cut while the interest rate on required reserve was set higher, commercial banks were allowed to cash compulsory bills before they were due or trade them on the open market; signals of supply of loans to investors in realty and stock markets were also given; the band around the exchange rate were set at ± 3% as from Nov. 6, 2008. After these measures were taken, the economy showed encouraging signs: the banking system got busier and flows of deposits and loans reassumed their normal speeds. Operations in the market, however, were not much improved; the cash flow slowed down; and the supply of bank loans and access to bank loans for companies were not as smooth as expected.

Figure 1: Changes in main rates in 2008 (%)



Source: GSO

Although the implementation of the monetary policy helped stabilize the economy at its macro level, Vietnam still faced a danger of depression. The Government had to employ some instruments of the fiscal policy, introduced five groups of measures to stimulate the economy in 2008, cut taxes and offered various tax incentives. As a result, by the end of the year, the drastic fall in the CPI was well under control and the aggregate CPI of 2008 rose by 22.9% over 2007; and the GDP grew by 6.18%. Although this growth rate was lower than the ones in previous years, it was considered as an encouraging result when the world economy suffered from the financial crisis and many economies faced negative growth rates. As noted by the Government, 2008 was the most successful year for the monetary policy when it helped reduce the economic recession in coordination with the fiscal policy.

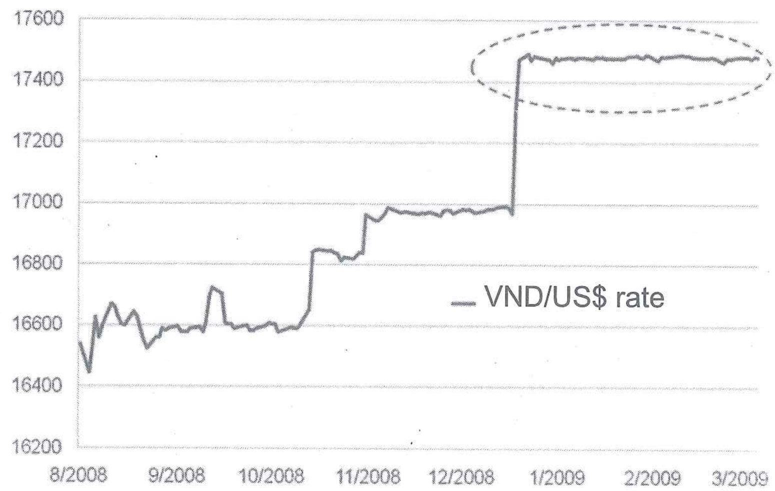
Table 3: GDP and CPI in 2006 – 2008 (%)

Year	2006	2007	2008
GDP	8.17	8.48	6.18
CPI	6.6	12.63	22.97

Source: Numerical data from the SBV and GSO

The year 2009 brought more difficulties and challenges. The Government kept following the cheap- money policy and paid full attention to stimulus packages, starting with 1 US$6-billion package – equaling 7% of the GDP, and then, interest- subsidized loans and higher minimum wage, etc., in order to encourage spending and investment. In early 2009, however, the implementation of the monetary is more careful, and the SBV took no stronger measures to cut the interest rate. As from Jan. 23, 2009, the base rate still stayed at 7% after some reduction, the refunding rate was 8% a year, and the rediscount rate was 6%. The cash reserve fell to 3% while the band around the exchange rate rose from ± 3% to ± 5% as from March 23, 2009.

Figure 2: Changes in the exchange rate in late 2008 and early 2009



Source: vneconomy.vn

In the context of global crisis, in spite of efforts to carry out flexibly and consistently measures within the monetary policy, the GDP in the first quarter of 2009 rose only by 3.1% as compared with the same period last year while the CPI rose by 14.4%. In addition, the stimulus package was carried out actively, which might lead to a huge budget deficit.

2. Effects and efficiency of the fiscal and monetary policies

a. Achievements:

The implementation of the fiscal and monetary policies in recent years proves their important role in the economy. Monetary instruments were employed in a flexible manner, which helped achieve targets set for each period. The following are some achievements:

- Success in controlling and regulating increases in the total liquidity, controlling and reducing the inflation, and decreasing remarkably the volume of bank notes in circulation thereby stabilizing the value of the domestic currency.
- The credit growth is well under control.
- The annual increase in the total liquidity is stable.
- The exchange rate is kept stable, the balance of payments is improved and the market prices are stabilized.

b. Shortcomings and their causes:

- The monetary policy caused many risks for commercial banks, especially the liquidity risk. Interaction between banks decreased and bad debts might increase.
- Some inconsistency was found in the way the SBV implemented of the monetary policy.
- The implementation of the monetary policy was somehow passive because in most cases it tried to repair some damage.
- The policy on the exchange rate sometimes caused unnecessary tensions on the foreign exchange market.

c. Estimate of efficiency of the implementation of the monetary policy employing regression analysis:

To estimate more exactly the efficiency of the implementation of the monetary policy in recent years, we have tested relationships between independent variables – change in interest rate (DLS), change in forward exchange rate (DKH), change in spot rate (DTG) and change in M2 (DM2) – and a dependent variable (GDP growth rate). All data were observed in the period from the first quarter of 2000 to the first quarter of 2009. The method employed is regression analysis based on SPSS.

- Regression results:

- Remarks about the results:

The 3-month interest rate, forward rate, spot rate and money supply all affect the GDP growth. Explanatory power of the model, however, is not high. It is perhaps because realities of the implementation of the monetary policy and Vietnam's macroeconomic situation.

+ In certain periods, especially the one between late 2007 and late 2008, the SBV employed interest and exchange rates rather flexibly and adjusted them continuously with the only aim of bringing the inflation under control at the expense of economic growth.

+ According to international financial theories, when devaluation (increased exchange rate) takes place, it promotes export and reduces import; while the trade balance is part of the function Y = C + I + G + X – M. Thus, increases in the ex-

Table 4: Results of correlation analysis

Correlations

		GDP	DLS	DKH	DTG	DM2
GDP	Pearson Correlation	1.000	-.262	-.217	-.209	.033
	Sig. (2-tailed)		.122	.204	.222	.850
	N	37.000	36	36	36	36
DLS	Pearson Correlation	-.262	1.000	.599**	.660**	-.334*
	Sig. (2-tailed)	.122		.000	.000	.047
	N	36	36.000	36	36	36
DKH	Pearson Correlation	-.217	.599**	1.000	.918**	-.142
	Sig. (2-tailed)	.204	.000		.000	.408
	N	36	36	36.000	36	36
DTG	Pearson Correlation	-.209	.660**	.918**	1.000	-.207
	Sig. (2-tailed)	.222	.000	.000		.225
	N	36	36	36	36.000	36
DM2	Pearson Correlation	.033	-.334*	-.142	-.207	1.000
	Sig. (2-tailed)	.850	.047	.408	.225	
	N	36	36	36	36	36.000

**. Correlation is significant at the 0.01 level (2-tailed).

*. Correlation is significant at the 0.05 level (2-tailed).

Table 5: Result of regression analysis of independent variables in relation to GDP

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	R Square	Adjusted R Square	Std. Error of the Estimate
	B	Std. Error	Beta					
(Constant)	.072	.002		43.197	.000			
DLS	-.622	.392	-.262	-1.584	.122	.069	.041	.00889032
(Constant)	.073	.002		37.818	.000			
DKH	-.202	.156	-.217	-1.296	.204	.047	.019	.00899298
(Constant)	.073	.002		36.949	.000			
DTG	-.226	.181	-.209	-1.244	.222	.044	.015	.00900995
(Constant)	.070	.005		13.664	.000			
DM2	.014	.072	.033	.191	.850	.001	-.028	.00920766

change rate and trade balance will help increase the gross output. Meanwhile, increased interest rate encourages savings, reduces investment, and leads to falls in the gross output. This argument, however, is not always true to countries suffering trade deficit like Vietnam. When the value of the VND falls, the export doesn't rise immediately (because of competition or ability to change the scope of production, etc.) while prices of imports certainly become higher because Vietnam has to import raw materials and machines and most buyers prefer imported goods. And as a result, quantity of import can hardly falls. Thus, falls in the value of the domestic currency in some cases may produce negative effects that reduce the current account and GDP.

+ According to Keynesian economists, the velocity of circulation is determined by the function Y/f (Y,i) where Y is gross output and i means interest rate. This argument suggests a way for determining the demand for money based on changes in total income and interest rate. Theoretically, increased supply of money may stimulate investment and spending, thereby helping increase the GDP. However, the above regression analysis shows that increases in the money supply in Vietnam only led to a very small change in its GDP. This explains why a cheap money policy in Vietnam could hardly produce any effects. One of causes of this situation is wrong and ineffective allocation and use of these increases in the money supply.

- Shortcomings in the model:

Firstly, the time for gathering a series of numerical data is short, from the first quarter of 2000 to the first one of 2009, so observations only approximate to minimum requirements that ensure reliability of a regression function. Using a series of data that reflects changes in these variables in a longer period of time, however, doesn't guarantee more exact results because their objective relations are affected greatly by interventions from the Government or the SBV.

Secondly, although data are supplied by official and public sources, their consistency and accuracy are not ensured, therefore regression measurements may be different from real changes and theoretical correlations.

3. Some suggestions on possible improvements in efficiency of the implementation of the monetary policy

Based on the above analysis and estimates, we suggest here some measures to carry out the monetary policy more effectively.

(1) Beefing up monetary and financial control: The role of the National Committee of Financial Control must be enhanced, especially in tasks of analyzing, predicting and warning problems with safety of the banking- financial system and finance market; working out strategy and orientation for the finance market; and building a mechanism for supervising the finance market. This Committee and the National Financial-Monetary Advisory Board could merge into a Financial- Monetary Supervision and Advisory Committee.

(2) Enhancing the efficiency of control over flows of investment and employing flexibly checking measures, especially indirect ones, when these flows swell too much and may cause fluctuations in the market.

(3) Restructuring the public sector: Low-interest capital supplied to state-owned corporations must be cut to the bone. Loss-making state-owned corporations and groups engaging in financial investment or realty market must be punished severely. Mechanism for running state-owned companies must be reformed in order to force them improve their competitiveness. Privatization must be open to foreign investors.

(4) Beefing up supervision of the banking system: Supply of inexact information about the banking system must be punished strictly. State-owned groups must be prevented from investing in banks and finance companies. legal infrastructure for acquisition and merger of banks must be built. Market for derivatives must be developed to support efforts to prevent risks in the banking service.

(5) Ministries of Finance and of Planning and Investment and the SBV had better cooperate closely and develop their human resources to enhance their analyzing and predicting ability.

(6) A system for publicizing full and exact economic and financial information must be established to satisfy the demand for such information and support formation of credit rating agencies.

(7) A market for bonds must be more active and effective by building a standard curve of in-

terest rate; encouraging development of credit rating agencies; stimulating participation of all sectors in the bond market; diversifying kinds of bonds and bills and issuers; and beefing up regulations and sanctions against violations in this market.

(8) Suggestions about the monetary policy:

- Mechanism for regulating the interest rate must be perfected and liberalized when appropriate. The open market operations must be developed. Reserve requirement and exchange rate must be employed more cleverly and harmoniously based on development of the market.

- Implementation of the monetary policy must be flexible, quick, strong and effective. After a monetary policy is adopted and proves effective, the SBV must be aware of its side effects in order to make timely adjustments avoiding such cases as the American one where a low interest rate was maintained for a very long time, which led to excessive growth of credit supply.

- Selecting and applying a monetary policy must be done independently and based on realities instead of applying mechanically a policy that proved successful in other countries. Malaysian success in dealing with the 1997 Asian financial crisis was due to its PM decision on its own monetary policy instead of relying on the IMF. This bold approach helped Malaysia keep itself away from the global financial shock and restructure its economy.

- The implementation of the monetary policy requires strict control and supervision, and sanctions against violation in order to ensure its efficiency. This is what China has carried out to keep its huge stimulus packages from being neutralized during the global economic recession.

4. Conclusion

Based on analyses and estimates of the efficiency of the implementation of the monetary policy in recent years, we suggest some measures to authorities with a view to enhancing the efficiency in the coming years. In our opinion, however, flexible cooperation between authorities and concentration of their activities are as important as selection of instruments in implementing the monetary policy to achieve specific targets in each period■

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