Review of 2011 Monetary Policy and Orientations for 2012

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ABSTRACT

Monetary policy is one of macroeconomic policies, by which the central bank controls and regulates money supply or interest rates to stabilize prices, attain economic growth, and create employment. In 2011, global economic instabilities and intrinsic problems of the domestic economy challenged the operation of macroeconomic policies in general and the monetary policy of the SBV in particular. As a state authority of currency and banking activities, the bank has attained some achievements by implementing strictly and cautiously the monetary policy, which contributes to the realization of general macroeconomic targets prioritized for inflation restriction, macroeconomic stabilization, and social welfare. The economic goals for the next few years such as macroeconomic stabilization, enhancement of economic growth quality, and unpredictable changes in the global economy remain challenges to the implementation of SBV monetary policy.

Keywords: monetary policy implementation, inflation, macroeconomic stabilization, SBV.

1. INTRODUCTION

The year 2011 saw the world economy continue its uneven recovery with two opposing trends. Developed countries – age-old flagships of economic growth – including the U.S., the Eurozone, and Japan had a slow and difficult recovery while emerging and developing economies are clearly demonstrating their leading role, contributing up to three quarters of the world's economic growth. Despite making some recovery, the global economy is still facing uncertainties that can cause widespread instabilities. Not only did the public debt crisis occur complicatedly in the Eurozone, but it was also a common problem to many big countries like the U.S., Japan and China. Stagflation runs a risk of reoccurrence when many countries are struggling with inflation returning to the high of 2008 and the warning about "growth crisis" in which economic growth is declining rapidly in most parts of the world. Additionally, instabilities in the financial and banking systems such as the bankruptcy and credit downgrade of numerous U.S and European banks are raising concerns over a double crisis like the one in 2008 and 2009.

The Vietnamese economy started the year 2011 with big challenges from its own economy and unpredictable events in the world economy. They include a two-digit inflation rate as of late 2010, huge deficits in trade and budget, the devaluation of the Vietnamese dong and complicated changes in the banking system and the financial market. These problems are intrinsic to the economy, persistent for years and left unsolved. Moreover, latent risks are more possible to develop when the openness of the economy is greater, amounting to 150% of the GDP. This makes the Vietnamese economy vulnerable to domination by the global environment. Therefore, strong measures should be taken to achieve macroeconomic stability and sustainable economic growth as well as ward off unfavorable changes in the global economy. This is the circumstances where the Resolution No. 11/NQ-CP dated February 24,

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2011 was promulgated along with comprehensive measures to accomplish the goals of inflation curb, macroeconomic stabilization, and national welfare, and serve as a lodestar for the operation of monetary policy of 2011.

2. CHALLENGES FROM UNPREDICTABLE CHANGES AND RISKS FROM THE WORLD ECONOMY

After the financial crisis, the global economy was still on the edge of declining, sustained many instabilities, and raised heated debate over whether its recovery trend was U, V, or W-shaped. Bouncing back from the bottom in the first quarter of 2009, the world economy gradually made a speedy recovery of 5.1% per year in 2010 that lasted through early 2011. Economic stimulus packages continued to be provided for flagship countries like the U.K., the U.S., and Japan to promote sustainable growth, but they were phased out in developing countries in early 2010 when the economy was recovering rapidly. Too speedy economic recovery of developing countries led to escalating inflation along with warning about China's red-hot growth of about 10%[1]. Inflation was contagious from developing countries to developed ones, raising it to a peak in 2008 and beyond targets of many countries due to soaring prices of materials. Tight monetary policy thus became prevalent. It was employed in both developed countries such as Sweden, Canada, and Australia; the ECB that raised interest rates for the first time since the financial crisis in 2008, and the U.S that terminated quantitative easing 2 in March 2011; and developing countries like China, India and the ASEAN that became more cautious when facing high inflation and risks from the global financial market.

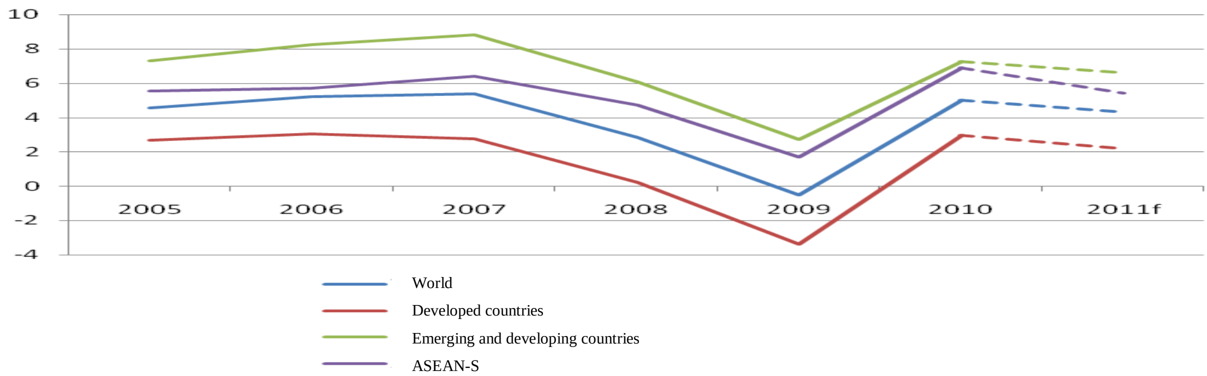


Figure 1: Economic growth of some blocs in 2005-2011 (%)

Source: imf.org

Since the second quarter, macroeconomic instabilities have become worse: decreased economic growth aroused worry about a second recession while the crisis in public debts rose to its peak. Economic growth relying on economic stimulus measures was quickly replaced by widespread decline when the government no longer supported it.

The economic growth of big countries like the U.S., the U.K. and Japan, and the Eurozone fell dramatically, which badly affected export-dependent economies, especially developing economies with a slower economic downturn. For example, China saw a growth rate of 9.1% in the third quarter, a record low during the past two years.

Upturns in trade and industrial output reached the same level as before the crisis. The PMI dropped to approximately 50[2]. Due to an across-the-board downturn worldwide, inflation and rises in prices of basic goods halted by August. Concern over inflation was temporarily alleviated while the crisis in public debts reached its peak, entailing turbulence in the financial market. The crisis not only occurred complicatedly in the Eurozone with a risk of dissolving the common currency. Moreover, warning about public debts spread to other big countries, especially the U.S. whose public debts equaled some 90% of the GDP. Even worse, the public debt crisis affected the financial and banking systems of many countries. A series of European commercial banks had its credit rating downgraded. Some other banks in the U.S. and Europe went bankrupt because of too much investment in Greek government bonds. Gold prices climbed to a record high of 1,923 USD/ounce on Sep. 6, 2011 while the US dollar fluctuated widely. The stock market witnessed continuous falls.

3. POTENTIAL RISKS IN THE DOMESTIC ECONOMY: A COMBINATION OF INTRINSIC PROBLEMS AND GLOBAL IMPACTS

Vietnamese economy in 2011 underwent more difficulties due to global economic instabilities and its intrinsic problems. It maintained a high but unsustainable growth. Additionally, the economy was heavily dependent on capital and yielded low investment efficiency despite total investments accounting for up to 40% of the GDP, twice as much as in many countries. Persistent and double-digit inflation as of late 2010 adversely affected production and livelihood.

Budget and trade deficits caused disturbance to exchange rates and foreign exchange markets particularly in some dollarized countries such as Vietnam. The country saw current account deficit remain high at 3.3% of the GDP from 2007 to 2010 while other Asian countries enjoyed surplus in the same period. As for budget deficit, it stayed at 5% of the GDP over years and showed signs of expanding in 2009 when a loosening fiscal policy stimulated the economy, which raised the budget deficit to 6.9% of the GDP in 2009 and 5.6% in 2010. According to economists, by international standards, Vietnam's recent budget deficit rose to 8-10% of the GDP, much higher than those in neighboring countries (from 2% to 4%).

Figure 2: Vietnam's current account deficit

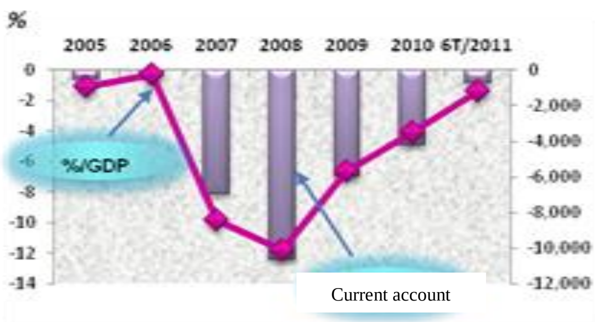
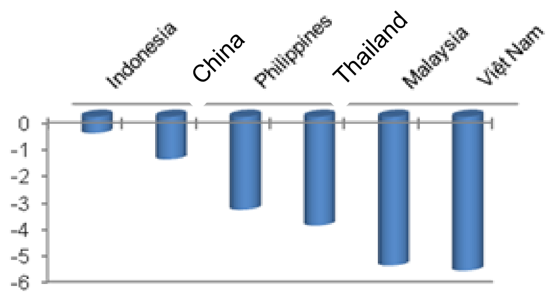


Figure 3: Vietnam's budget deficit (% GDP) as against other countries in 2010



Source: SBV, Ministry of Finance, IMF

While the financial market was disturbed by side effects of the tight macroeconomic policy, long-time shortcomings emerged. After economic stimulus measures were abolished in 2010, the tight fiscal and monetary policies adopted in 2011 aiming at curbing inflation helped regain the macroeconomic stability to a certain extent but they inevitably produced side effects on the economy. High interest rates affected business activity of the real economy. Furthermore, cuts in public investment caused continuous decline in the stock market. Banks' bad debts showed an upward trend despite controls by the SBV. The inter-banking market intermittently experienced wild fluctuations because some commercial banks ran short of liquidity, forcing the SBV to provide liquidity support as the last resort.

The fluctuations in the financial-banking sector arose from macroeconomic instabilities, especially from the financial market, which was in its early stage of development, so the banking system was burdened with capital mobilization while other sources of finance are not as diverse and abundant as in countries with deep financial markets. In reality, nevertheless, there is no denying that the financial strength and risk management of commercial banks were not good enough to protect them from policy and economic shocks.

4. OPERATION OF SBV MONETARY POLICY, A COMPREHENSIVE MEASURE BY THE GOVERNMENT: MACROECONOMIC STABILITY IS BEING ESTABLISHED.

Policies to cope with economic instability: government's flexible adjustment to overall goals and targets.

For medium-term goals, the government has switched from striving for high growth rates as in the past few years to enhancing growth quality and attaining macroeconomic stability. After setting high growth rates of 7-8% as main goals for many years, the government aimed for macroeconomic stability in 2011 that was not just a short-lived but long-term goal for the coming years. The switch of general targets to macroeconomic stabilization, inflation curb and social welfare is conducted through the coordination of fiscal, banking, monetary and trade policies. The year 2011 was expected to witness a GDP growth of 6% as well as much lower budget deficit and monetary targets than before.

Policy responses to recent changes and shocks demonstrated the flexibility of the government in switching short-term goals and consistently taking measures to achieve prioritized goals. After endeavors to reduce soaring inflation in early 2008 and deal with the economic crisis in 2008-2009, Vietnam as well as other countries implemented economic stimulus policies to fight external influence. Since late 2010, however, to cope with inflation risks, the Vietnamese government has adopted tight fiscal and monetary policies through Resolution 11/NQ-CP dated Feb. 24, 2011 concerning principal solutions to inflation control, macroeconomic stability and social welfare. The resolution also consists of basic policy solutions in the context of macroeconomic instabilities.

Tightening of monetary policy and coordination of other macroeconomic policies

The tight monetary policy embodied in numerous monetary and banking solutions was carried out proactively and consistently by SBV pursuant the Resolution 11. At the very start of 2011, SBV issued an instruction that requires branches of SBV and banking institutions to implement monetary and banking solutions to control inflation, macroeconomic stabilization and social welfare. The monetary growth target was lowered against previous years (credit growth less than 20% and total liquidity up 15-16%), but the banking system should supply enough capital for business and give top priority to loans for development of business, agriculture and rural development, export, support industries, and operation of small and medium enterprises. Moreover, it should reduce the supply of loans to non-production sectors and keep interest rates and exchange rates at reasonable levels appropriate to macroeconomic conditions. Instruments of the monetary policy, such as interest rate, open market operations, refinancing and required reserve, were flexibly employed by SBV to regulate the money supply.

In an attempt to keep credit growth under 20% in 2011, SBV asked banking institutions to adjust their plans on growth of credit and assets, increase proportion of loan for production – business, agriculture, export, support industries, and small and medium enterprises, and reduce the supply of loans to non-production activities, especially investment in real estates and securities. Specifically, credit limit for non-production was 22% through June 30, 2011 and 16% at the end of 2011 according to Instruction 01/CT-NHNN. Furthermore, SBV adjusted the rate allowed for risk provision for gold-secured loans as high-risk assets up to 250% and directed the supply of credit to important and effective economic activities.

Interest rates were regulated flexibly, conditioning that depositor interest was guaranteed and the goal of inflation curb was not compromised. Specifically, SBV increased the refinancing interest rate five times from 9% to 15%; overnight lending rate in inter-bank e-payment from 9% to 16%, adjusted rediscount rate from 7% to 13% per year, and interest rates for open market operations from 10% to 15% per year and then down to 14%. Borrowing and lending rates were kept at reasonable levels to proactively restrict inflation, enhance the value and attractiveness of the Vietnamese dong against foreign currencies and control credit transfer from VND to foreign exchange. SBV also promulgated many legal documents on market stabilization such as the circulars on the lending charge, application of demand deposit rate to premature withdrawal, and a ceiling of 14% per year for borrowing rate at commercial banks, a ceiling of 6% per year for one-month and call deposits, and a ceiling of 2% for deposits in foreign currency. Together with the interest rates, SBV flexibly operated the open market operations and provided liquidity to commercial banks but kept foreign currency in check. It also increased required reserve ratio for foreign exchange deposits to 4% and applied required reserves in foreign exchange to all banking institutions.

SBV's exchange rate policy and operation of foreign exchange market were appropriate for the demand for and supply of foreign currency, enhanced the liquidity of the market, improved balance of international payments, increased foreign exchange reserves and stabilized the gold market. Inter-bank average exchange rates were raised by 9.3% in February and the trading band at commercial banks was narrowed from +3% to +1%; a ceiling on borrowing rate for US-dollar deposits was set and lowered timely; and interventions to forex market were carried out with reasonable volumes accompanied by measures to stabilize the gold market and require banking institutions to control mortgage loans and gold-secured loans for prevention of speculation. To rapidly stabilize the forex market, SBV imposed strong and enduring measures in its connection to other policies and related authorities in attempts to reduce trade deficit, promote export, strictly control the supply of loans in or sale of foreign currencies for import of items included in the list of non-essential imported goods, and inspect and handle strictly illegal trade in foreign currencies and gold.

SBV has employed supportive and administrative measures selectively to guarantee monetary and macroeconomic stability as well as market disciplines and the execution of the supervision system. The use of administrative tools can cause side effects but is necessary in the event of macroeconomic instability. Field research shows that in an effort to support the monetary policy, SBV implemented administrative solutions flexibly and selectively by strictly controlling and stabilizing the gold and forex markets as well as the interest rate and monetary markets. It also boosted the inspection and supervision of banks' activities such as guaranteeing adequacy ratios in banking activities, focused on the inspection of the supply of loans, restructured debt repayment time, categorized credit, set proportions of profit turned into risk provisions, and promoted on-the-spot inspection of the supply of loans to the non-production sectors and credit quality. Punishments against violations of banking regulations were strengthened.

The communication task force has been very helpful for SBV's monetary policy. Guidelines and orientations for implementation of the monetary policy were announced through the messages of SBV representatives that acted as a traditional approach channel for market participants. By the channel, the market adjusted its own behavior, reduced information interference and tendency to speculation, and created a general consensus about macroeconomic policies. To increase the transparency of policies, SBV built a dialog mechanism between itself and commercial banks, especially 12 banks with big market shares in order to establish a close connection between policy-makers and market components. The act of allowing commercial banks to participate in the policy-making process helped enhance their responsibility in policy implementation and increase the interaction between market participants and authorities. This brought promulgated policies closer to reality.

Coordination of other macroeconomic policies, mainly the fiscal policy, to enhance execution productivity of the monetary policy: The fiscal and monetary policies are the most important in the set of government policies. Therefore, they require a close and consistent coordination to achieve general goals. Budget, public debts and development of the bond market have mutual effects on the monetary policy and reflect the coordination of macroeconomic policies. In retrospect, the SBV operation of monetary and banking polices was consistent and showed improvements in transparency and attachment to the fiscal, commercial, and other policies to maintain macroeconomic stabilization. Due to strong measures to tighten the fiscal policy and cut 10% of regular expenditure and pubic investments, budget deficit was estimated to drop to 4.9% of the GDP in 2011 instead of 5.3% as planned, which promoted the positive effects of the fiscal policy on inflation control along with the monetary policy.

The result of the implementation of monetary policy in connection with other macroeconomic policies is reflected through economic progresses of 2011 as follows:

A slowdown in economic growth was appropriate for inflation curb and macroeconomic stabilization: Economic growth reached 5.8% for the first nine months and was estimated at 6% for the whole year. This had been the lowest growth rate since the 1997-1998 Asian financial crisis. Declined economic growth was seen in most industries because of tight macroeconomic policies and high inflation. Consumption and investment fell year on year, indicating a decrease in domestic demand. However, foreign net demand remained high due to exports, while global economic growth decreased. This partly demonstrated the competitiveness of Vietnamese goods and services in the international market. Compared with other countries, Vietnam was among countries that enjoyed the highest growth in the region.

Inflation ascended as of late 2010 and descended from May 2011: Inflation soared in the first four months, averaging a rise of 2.3% per month. This was not the first time that inflation skyrocketed, but it had persisted since Vietnam's deeper integration into the global economy, or rather since its accession to the WTO in 2007. In the global whirlwind of rising prices, high inflation was also found in other countries. With the broad openness of the Vietnamese economy, imports made up a share of 70-80%, which created pressure on domestic prices. Inflation growth was much higher in Vietnam than in neighboring countries. This indicated that the causes came from not only the world economy but also the domestic economy itself. According the government, the causes were the prolonged loosening of fiscal and monetary policies, increased outstanding debts and credit, all-time high budget deficit; unreasonable structure and investment, low labor productivity and investment efficiency; poor management of pricing and distribution of goods; increased costs of factor inputs and business, etc. Per tightening macroeconomic policies to cut aggregate demand in May 2011, the pressure for rising prices diminished and inflation went down to an average of 1.1% per month. Nevertheless, inflation of 2011 was still high, at a two-digit level of 18%.

The current account balance was improved partly due to cuts in budget overspend: Measures to tighten the macroeconomic policies, promote the export, and reduce the trade deficit proved effective. Import was restricted and grew less than export. This was because of declining consumption and investment as well as the government's restriction on imports of unnecessary goods. Therefore, trade deficit was kept at about $10 billion, lower than that of 2010 and lower by far than the expected $14 billion presented in early 2011 by the National Assembly. This helped improve the balance of international payments.

The banking system was turbulent at some points and quickly bounced back: In the first quarter, interest rates rocketed under the influence of inflation and the tight monetary policy. As of May, however, the pressure of rising interest rates diminished because macroeconomic conditions became stable, inflation fell and liquidity of banking institutions improved. At the same time, SBV carried out tough measures to handle the skyrocketing of interest rates at many commercial banks by strictly inspecting and overseeing the application of interest rate caps. In August 2011, interest rates fell to 17-19% for production loans, as a commitment by the SBV Governor. In the forex market, exchange rates underwent dramatic changes in the first three months. After SBV took intervening measures, they were kept in check. August 2011 saw an increase in exchange rates, but is causes came from unusual changes in the global gold market that provoked speculation and produced pressure on the forex market and exchange rates. The difference between the domestic and global gold prices amounted to VND4 million per tael at some points. To stabilize the gold market, SBV implemented measures to narrow the gap, supplement sources of gold supply, strictly control mortgage and gold-secured loans, and prevent speculation. As a result, the forex and gold markets were gradually stabilized.

Orientations for monetary policy in 2012: Continuing to pursue goals of inflation restriction and macroeconomic stabilization

Global economy continues to expose potential risks

Although the world economy can hardly suffer a second double crisis as warned in mid-2011 because the U.S economy has demonstrated more certain signs of recovery since Q4 2011, the global economy cannot be expected to achieve a good growth or firm recovery. According to IMF, the global economic outlook is rather fragile with a growth of 4%. This figure is 1.8% for the U.S. and 1.6% for the Eurozone. However, the public debt crisis that affects powerful countries in the common currency area lowers the expected growth. Asian countries including Japan are thought to become the driving force for the world economy due to their dynamic economies and increased regional cooperation. Japan will achieve an economic growth of 2.3% in 2012 after a growth of -0.5% in 2011 while other Asian countries' growth will stand at 8.0%, slightly lower than last year at 8.2%. In that context, developed countries will continue with macroeconomic policies that support the financial system and the economy. Meanwhile, in developing countries, tight monetary policies will persist, but they may not be carried out as strictly as in 2011.

Domestic economy aimed at macroeconomic stability and enhancement of growth quality

At the Central Conference 3, Term XI in October 2011, the year 2012 and the 2011-2015 period were aimed at inflation restriction, macroeconomic stability and better social welfare along with changes of the economic growth model and restructuring of the economy. Issues approved at the Resolution introduced by the 13th term National Assembly on Plans for Socioeconomic Development in 2012 are consistent with the VCP guidelines on macroeconomic stabilization. They consist of some major targets for 2012 such as GDP growth of 6-6.5%, aggregate export turnover up by 13%, trade deficit at 11-12% of the aggregate export turnover, budget deficit kept under 4.8% of the GDP, gross investment making up 33.5% of the GDP, and CPI rise under 10%.

Monetary policy in persistent pursuit of inflation curb and macroeconomic stabilization

Orientations for the operation of the monetary policy of 2012 are specified in the Government Report at the second session of the 13th National Assembly. They are concerned with the tight, thorough and flexible operation of the monetary policy, combination of monetary and fiscal policies to control inflation and confine increases in total liquidity and outstanding loan to the proposed targets in the Resolution 11 of 2011; keeping interest rates at a reasonable level; proactive and suitable adjustments to exchange rates to avoid wide fluctuations; close supervision of commercial banks' lending activities; guarantee of sufficient capital for production; strict control over the supply of loans to realty and securities businesses; control of bad debts, and guarantee of liquidity and system safety.

In face of unforeseen macroeconomic changes, SBV's operation, employment and coordination of the monetary policy instruments will be more flexible depending on economic conditions. At the same time, flexible measures in the monetary policy should be implemented cautiously in order to reach general goals of inflation restriction, macroeconomic stabilization, economic growth in terms of quality and economic side effect reduction. Aside from the main instruments of monetary policy, it is also important to maintain the inspection and supervision roles of SBV towards banking institutions to establish market disciplines and build a firm foundation for the implementation and optimization of the monetary policy. Additionally, the fiscal policy should be carried out more strictly, especially in cutting public expenditure. It is also of necessity to avoid the fact that the fiscal policy is rarely modified while the monetary policy constantly changes in line with economic changes. This is to gain the best results for macroeconomic goals.

To sum up, along with the VCP and government's goal switch, the monetary policy of SBV has demonstrated the positive impacts of its monetary policy on the economy. The banking sector still faces challenges in the forthcoming years regarding a requirement to restructure it. The restructuring is one of the three principal components of economic restructuring along with the restructuring of investment and state-owned enterprises. By fulfilling its commitments to implement administrative solutions flexibly and consistently as well as building trust to the market, the monetary policy remains an essential factor to achieving general macroeconomic goals■

Notes:

[1] Economic growth was positive in 2010 with China's growth at 9.7% and India's at 7.8%

[2] PMI- Purchasing Managers Index varies between 1 and 100 in which 50 is the boundary between contraction and expansion of production.

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