INFLATION TARGETING AND THE IMPLICATIONS FOR MONETARY POLICY FRAMEWORK IN VIETNAM
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Research report RS - 02

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INFLATION TARGETING AND THE IMPLICATIONS FOR MONETARY POLICY FRAMEWORK IN VIETNAM
INTRODUCTION

In recent years, high inflation has always been a potential threat to the macroeconomic stability and long-term economic growth in Vietnam. The process of international integration and financial liberalization, loose macroeconomic foundation lead many people to have doubts about the stability and control of inflation in the upcoming years. This requires that we must frankly recognize the operating mechanism of monetary policy in our country today. A question which has been attracting the attention of many National Assembly deputies and economic experts is whether the operating mechanism of monetary policy at present is not really effective in the context of domestic economic that is complicated and increasingly has deeper integration into the world’s economic turmoil.

With multi- monetary policy objectives, we expect to accelerate the growth rate, to control price level- inflation, to stabilize monetary as well as to use monetary policy as a supplementary instrument to stabilize budget, reduce poverty and ensure national security. In recent years, this mechanism has clearly revealed its limitations. Experiences of many countries around the world indicate that inflation targeting may be a reasonable choice for monetary policy in our country in the future in which maintaining a reasonable and stable level of inflation becomes primary objective of monetary policy to ensure macroeconomic stability. Prime Minister Nguyen Tan Dung during the question-and-answer session of National Assembly deputies at the 2nd session of the National Assembly XIII also emphasized that in the upcoming time the government will “actively implement the inflation targeting”.

To satisfy these requirements, this study was implemented to generalize the basic theoretical issues about the inflation targeting, applying the experience of countries around the world as well as evaluating the real situation and applicability of inflation targeting mechanism in Vietnam. Especially, the study proposes the particular roadmap and groups of solution to apply this mechanism in our country in the future. This is valuable and timely contribution for legislature and government to review and take concrete action to reform the monetary policy mechanism in the context of restructuring the whole economy of our country.
This is a study in a series of studies based on empirical evidence associated with macroeconomic policies that are being implemented within the framework of the project “Supporting for advisory capacity, verification and monitoring macroeconomic policies” of the Economic Committee of National Assembly funded by UNDP. Research is reported by the authors of Vietnam Institute of Economics belonging to the Vietnam National Centre for Social Sciences and Humanities. All considerations, analysis, and evaluations in this report represent the independent views of the authors and do not necessarily reflect the views of Economic Committee and Project Management Unit.

It’s our honour to introduce this study to readers.

**Nguyen Van Giau (phD)**

Member of National Assembly Standing Committee

Chairman of the National Assembly Economic Committee
This research has been conducted in the framework of project “Supporting for advisory capacity, verification and monitoring macroeconomic policies” controlled by National Assembly Economic Committee with the financial support of The United Nations Development Programme (UNDP).

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The authors would like to sincerely thank to Mr Nguyen Van Giau, Nguyen Van Phuc, Nguyen Duc Kien, Nguyen Minh Son, Nguyen Tri Dung, To Trung Thanh, Rodney Schmidt, Vu Quoc Huy, Nguyen Dai Lai and Mrs Le Thi Ngoc Lien for their significant contributions and supports.
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<th>Description</th>
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<tr>
<td>ADB</td>
<td>Asian Development Bank</td>
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<tr>
<td>MP</td>
<td>Monetary Policy</td>
</tr>
<tr>
<td>SBV</td>
<td>State Bank of Vietnam - SBV</td>
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<tr>
<td>IT</td>
<td>Inflation Targeting</td>
</tr>
<tr>
<td>Implicit IT</td>
<td>Implicit Inflation Targeting</td>
</tr>
<tr>
<td>Partial IT</td>
<td>Partial Inflation Targeting</td>
</tr>
<tr>
<td>FFIT</td>
<td>Full-fledged inflation targeting</td>
</tr>
<tr>
<td>M1</td>
<td>Narrow money</td>
</tr>
<tr>
<td>M2</td>
<td>“Intermediate” money (Board Money)</td>
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<tr>
<td>MB</td>
<td>Monetary Base</td>
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<tr>
<td>MS</td>
<td>Money Supply</td>
</tr>
<tr>
<td>OMO</td>
<td>Open Market Operation</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>WTO</td>
<td>World Trade Organization</td>
</tr>
<tr>
<td>GSO</td>
<td>General Statistics Office</td>
</tr>
<tr>
<td>VND</td>
<td>Vietnam dong</td>
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<td>USD</td>
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PREFACE

Over the past 25 years, Vietnam has made progress in opening up the economy in which competition is increasingly improving when our country has moved from centralized economy to market-oriented economy. Vietnam’s economy has actually grown, which contributed significantly to the alleviation of hunger and poverty. However, there are concerns that the policy of Vietnam was not adequate to the pace of current liberalization. Based on the observations of establishment methods and implementation of economic policy in Vietnam, it appears growth is more focused, for reasons mentioned above; it is difficult to stabilize the price level.

It can be said that Vietnam is the typical evidence of high inflation rate in which there are certain achievements in the fighting against inflation through operating monetary policy solutions. We have tasted the severe impact of high inflation in the period 1976-1985 due to the defects of economic policy (if the price level taken in 1976 was 100, that of 1981 would 313, that of 1984 would 1,400; that of 1985 would 2,390). With the high inflation, the economic fell into whirlpool of stagnation; macroeconomic suffered constantly crisis; production was stagnated; commodity circulation was disordered; and ultimately, people’s lives were difficulty. In 1995, the inflation rate was at 12.9%, and then reduced to lowest point at -0.5% in 2000. However, inflation rate continued to witness the fluctuation, and then increased to 12.7% in 2007, 22.3% in 2008 and 6.9% in 2009. In order to minimize the damages and losses from Global Finance Crisis in 2009, the government brought out quickly the macroscopic policies such as monetary policy, exchange rate policy, trade policy, etc... in which the most prominent one is the stimulus package to prevent the economic crisis, to ensure stability and to maintain the social security system.

However, the opposite side of the stimulus package could bring the risk of inflation due to loose monetary policy and fiscal expansion to stimulate the economy. In 2010, the inflation rate increased to 11.75% while inflation rate in 2011 was 18.13 % comparing to the same period in 2010 (average CPI in 2011 increased to 18.59% compared to average CPI in 2010). Movements

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1 Vietnam bank: Building and development process, National Politics Publisher (1996)
2 General Statistics Office
of annual inflation suggest that the risks of high inflation remain potential threat to stability and sustainable economic growth of our country in the future. Enhancing international integration and promoting financial liberalization commitments of the World Trade Organization plus macroeconomic background stability has not yet strongly stabilized in Vietnam, which led people to have suspicions about possibility of inflation in the future which will be stable and controlled at a reasonable level that has benefit for sustainable economic growth. An issue that has attracted to the attention of policy makers is whether the operating mechanism of monetary policy is current ineffective, and have no longer relevant in the context of domestic economic becoming more complex and integrating deeply into the world economy with high fluctuation.

Since then, Vietnam has been implementing monetary policy with multi-objectives. We not only expect to accelerate growth, to leave low-income countries, and to resolve employment, but also expect to control price level and inflation, to use monetary policy as a supplementary instrument to stabilize budget, to reduce poverty, and to ensure national security. Implementation of monetary policy with multiple objectives with nominal anchor being board money (M2), we have made certain achievements in the innovation process. However, the operating mechanism of monetary policy recently has begun to reveal its limitations.

Another question is what we should do when we have to accept the fact that growth quality was low while inflation rate increased sharply? How our economy can both control inflation and continue to grow at a reasonable rate is a thorny problem. Learning from the international experience in the world, it can be said that inflation targeting is the future direction for Vietnam’s economic situation. Maintaining low and stable inflation should become the primary target of monetary policy to ensure macroeconomic stability in which it also simultaneously need to be associated with improving efficiency of policies in term of economic structure. However, an important issue is whether Vietnam is currently eligible to apply monetary policy framework of inflation targeting or not yet? This is the goal that Research team set out when choosing topic: “Inflation targeting and the implications for monetary policy framework in Vietnam” to review and evaluate the implementation of inflation targeting in Vietnam.
CHAPTER 1

GENERAL ISSUES

STUDY OBJECTIVES AND RESEARCH QUESTIONS

The study will focus on four main issues:

• Based on the study of basic issues of inflation targeting, international experience in applying monetary policy framework of inflation targeting and reality of Vietnam put an answer on whether to apply the monetary policy framework of inflation targeting in Vietnam or not.

• Evaluate the operating mechanism of monetary policy in Vietnam at present and study the applicability of monetary policy framework of inflation targeting in Vietnam.

• Propose scenarios and roadmap applying monetary policy framework of inflation targeting in Vietnam.

• Propose groups of solution to apply monetary policy of inflation targeting in Vietnam in the future.

In order to clarify the contents above, the study will answer the following questions:

• What’s monetary policy framework of inflation targeting?

• Compare the monetary policy framework of inflation targeting to traditional monetary policy framework (advantages/ disadvantages)

• Why do many countries choose monetary policy framework of inflation targeting?

• How do these countries apply the monetary policy framework of inflation targeting?

• What is the prerequisite to apply successfully monetary policy framework of inflation targeting?

• What is current situation of operating mechanism of monetary policy in Vietnam (result, limitation)?

• Should the monetary policy framework of inflation targeting be applied in Vietnam?
• Has Vietnam satisfied conditions to apply monetary policy framework of inflation targeting yet? To what extent are these conditions satisfied?

• What is roadmap and solution in applying monetary policy framework of inflation targeting in Vietnam?

**RESEARCH METHODOLOGY**

The study mainly used qualitative research; based on data collected to evaluate the operating mechanism of monetary policy; and simultaneously analyze the applicability of monetary policy framework of inflation targeting in Vietnam.

The study which used inductive methods, and interpretations, went from general to specific issue, and linked theory with practice. Besides, the study also used scientific methods such as statistical analysis, comparison, synthesis, and expert interviews.

The qualitative analysis includes:

• Systematize the basic issues of operating monetary policy framework of inflation targeting.

• Compare the operating mechanisms of monetary policy framework of inflation targeting to traditional operating mechanism.

• Assess the impact of the implementation of the monetary policy framework of inflation targeting on the macroeconomic objectives (growth, inflation), and on the general economy.

• Evaluate the operating mechanism of monetary policy in Vietnam at present.

• Evaluate the applicability of monetary policy of inflation targeting in Vietnam.

**SCOPE OF STUDY**

The study will focus on the operating mechanism of monetary policy in the period of 2000-2010 in Vietnam, and issues raised. On the basis of further analysis of international experience, the conditions for applying successfully inflation targeting framework and evaluating the applicability of the monetary policy framework of inflation targeting in Vietnam.
ORGANIZATION OF STUDY

In addition to the preface, conclusion, references, and lists of tables, list of figures, report will include six parts: (i) general issues; (ii) monetary policy and operating monetary policy of inflation targeting; (iii) the experience from other countries in applying and implementing monetary policy framework of inflation targeting; (iv) reality of operating monetary policy in Vietnam; (v) evaluating the ability and proposing the establishment of premises for implementation of monetary policy framework of targeting inflation in Vietnam; (vi) roadmap and solution to apply monetary policy framework of inflation targeting in Vietnam.

OVERVIEW OF STUDIES ON INFLATION TARGETING

Overview of international studies

There are many international researches about monetary policy framework of inflation targeting in which these researches focus on the basic content of inflation targeting framework including: (i) concept and definition of inflation targeting framework; (ii) the basic elements of the inflation targeting framework; (iii) the prerequisite for applying successfully the inflation targeting framework; (iv) comparing the advantages/disadvantages of inflation targeting framework application to previous monetary policy (anchor with exchange rate, or anchor with the money supply); (v) the impact of applying inflation targeting framework on the macroeconomic results; (vi) the ability to confront the inflation targeting framework with shocks (e.g. commodity price shocks, crisis shocks); (vii) the experience from industrialized and emerging countries in applying inflation targeting framework and lesson learned; and (vii) other relevant content.

The following section will discuss in more detail about these issues.

The concept and key elements of inflation targeting
Mishkin (2000, 2001) provides an overview of the implementation of inflation targeting in transition and emerging economies in which the author refers to the advantages and disadvantages of monetary policy strategy with inflation taken as target while a number lessons learned from some international experience such as Chile, Brazil. The author argues that inflation targeting which is monetary policy strategy has been successfully used in industrialized countries, and has been becoming an attractive option for emerging market countries such as Chile, Brazil, Czech Republic, Poland, and South Africa.

According to the author, the developing countries (including emerging and transition economies) have already experienced financial crisis due to the fixed exchange rate mechanism. Therefore, finding another anchor for monetary policy instead of the exchange rate mechanism is necessary.\(^3\)

In this project, Mishkin provide a clear definition of inflation targeting. According to author, the inflation targeting consists of five key elements: (i) announcing to the public about quantitative inflation target in medium-term; (ii) institutional commitment to stabilize price as a primary objective of monetary policy; (iii) informational strategy including many variables (not just total money supply or the exchange rate) which is used to establish policy instruments; (iv) increasing transparency of monetary policy through the announcing to public and market about plans, objectives, and the decisions of the Central Bank; and (v) increasing accountability.

Some authors believe that inflation targeting mainly use inflation forecasts as an intermediate guide for monetary policy and operating policies in a transparent framework to increase accountability.\(^4\)

Operating monetary policy framework of inflation targeting depends on four factors: (i) the inflation targets being as the anchor for monetary policy; (ii) the independence of the Central Bank in setting up inflation objectives; (iii) the ability to predict and deal with inflation; and (iv) the level of transparency and responsibility in monetary policy.\(^5\)

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\(^3\) In other study, Mishkin provides the disadvantage of the anchor exchange rate (1998)

\(^4\) Andrea Shaechter, Mark Stone and Mark Zelmer (2000)

\(^5\) Klass Schmidt-Hebbel and Matias Tapia (2002)
Monetary policy framework of inflation targeting should ensure the combination between institution and operation: (i) the inflation targets should be announced publicly; (ii) it needs to have commitment to stabilize exchange rate stability; (iii) operating monetary policy uses inflation forecasts as operational targets; (iv) there should have clear explanation about monetary policy; (v) responsibilities of the Central Bank need to be clearly defined. 6

According to Geoffrey Heenan, Mareel Peter, and Scott Roger (2006), transparency is the central element in the most aspects of the design and operation of the inflation targeting framework. There are three factors related closely to transparency, which is (i) institutional agreement about supporting inflation targeting (including the independence of the Central Bank, accountability, agreement about decision making); (ii) the design of inflation targeting; and (iii) communication policy of the Central Bank.

Why is inflation targeting (IT)? Reasons for applying IT? Advantages/ Disadvantages of IT

Charles Freedman and Douglas Laxton (2009a) refer to the core issue about why the Central Bank choose low inflation rate as their policy objectives and why many countries in the world choose inflation targeting as framework to achieve that goal. The authors went deeper analysis of the costs of inflation including their role in creating boom period-recession. High and fluctuate inflation rate in the majorities of countries in the previous period was followed by high volatility in output and employment, by low growth in productivity and potential output. High inflation environment damage a lot of economic activities.

Over the past two decades, many industrial countries and emerging markets have applied inflation targeting as their monetary policy framework. The authors suggest the common reason of these countries in applying IT is that these countries have met the difficulties in using other nominal anchors (the exchange rate targets and monetary targets), as well as the desire to reduce inflation and anchored inflationary expectations through a simple target which can be observed.

Mishkin (2000, 2001) suggests that the advantages of the monetary policy framework of inflation targeting include: (i) it allows the Central Bank to focus on domestic aspects, and to

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6 Takatoshi Ito and Tomoko Hayashi (2003)
react with shocks which affect the economy; (ii) this framework can work well without the need of stable relationship between money supply and inflation; and (iii) public and market can better understand the goals that the Central Bank pursue, so that the transparency and accountability will increase.

The disadvantage of monetary policy framework of inflation targeting is also mentioned, which includes: (i) monetary framework not only is too strict but also just focuses only one goal, and could increase the volatility of economy by not aiming at growth and employment; (ii) the inflation targeting cause accountability to be poorer in performance because inflation is very difficult to control as well as the lag of policy is long; (iii) IT framework does not help to eliminate the overwhelming fiscal policy; and (iv) IT framework requires flexibility in exchange rate, yet flexible exchange rate may increase the uncertainty for financial stability.

Debelle (1999) indicates that the critics shows that the target only directing toward inflation of the Central Bank but ignoring targets of output and employment is the mistake. In reality, particularly in a case of Australia, the monetary policy framework strategy of inflation targeting is flexible enough to allow output and inflation to trade-off in short-term. Price stability in the medium term can be maintained while allowing the inflation to change in short-term, and thus facilitating the fluctuation of lower output.

Charles Freedman and Inci Otker-Robe (2010) believe that one of benefits of operating monetary policy framework of inflation targeting with float exchange rate mechanism is to make the participants in economy to be more aware of two-way risk in exchange market; so that IT will lead the use and development of hedging facilities, and create the motivation for reducing the deviation of foreign currency on balance sheet. The exchange markets which are more developed will help emerging economies to operate monetary policy of inflation targeting to solve exchange rate issues.

*International experience in the application and implementation of inflation targeting*

So far, there has been many authors of many the Central Bank around the world who study the international experience in bringing out the application and implementing inflation targeting including Charles Freedman (Canada), David Vavar (Czech Republic), Klaus Schmidt-Hebbel
A number of studies of International Monetary Fund (IMF) which include Masson, Savastan and Sharma (1997), Schaechter, Stone, and Zelmer (2000), Carare et al. (2002) and Stone (2003), focused on the difficulties that emerging countries have to face when these countries apply inflation targeting. The authors provide the prerequisites that need to be satisfied before making any IT application. However, among the authors are not yet unanimous about conditions which need to satisfied before inflation targeting is applied to the emerging economies.

Andrea Schaechter, Mark R. Stone, và Mark Zelmer (2000) who carried out the empirical research of the application of inflation targeting from industrial countries and emerging markets, indicate that the foundation for full-fledged inflation targeting (FFIT) that is established successfully includes a strong financial position and stable macroeconomic, well-developed financial system, independence of the Central Bank’s instruments and one instruction/ statement to achieve price stability, the comprehension of transmission mechanism of monetary activity and inflation, reasonable methodology to build inflation forecast, and transparency of monetary policy to establish accountability and credibility. Many of above factors, especially a strong financial position, are necessary for an appropriate monetary policy. Moreover, these elements don’t need to be set all before all countries begin the transition to inflation targeting framework entirely.

Mishkin (2004) considered aspects of countries with transition and emerging economies in order to inflation targeting can be done, the difficulties that country is facing, and thus the difference between the transition economies and developed countries. The difficulties and differences include: (i) the weak fiscal institutions, (ii) the weak financial institutions, (iii) the low reliability of the monetary institutions, (iv) the dollarization, and (v) the vulnerability of these countries in the face of inflow capital suddenly stopped. According to the authors, the countries with transition and emerging economies should concentrate on the institutional development to ensure the monetary policy strategy of inflation targeting creating the better
macro results. In this study, the authors take two case studies which are Chile and Brazil in which these two countries have valuable experience in reducing inflation and maintaining macroeconomic stability from high inflation through implementing monetary policy framework of inflation targeting.

Andrea Schaechter, Mark R. Stone, and Mark Zelmer (2000) analyzed the differences between industrial countries and emerging market countries (Brazil, Chile, Czech Republic, Israel, Poland, and South Africa) in the preparing the foundation, and the conditions for the application of IT and FFIT in such aspects: (i) institutional framework, (ii) the issues of operating monetary policy, (iii) the organizational aspects of the Central Bank, and (iv) the transition issues.

- **Institutional Framework**: In contrast to industrial countries, emerging market countries generally direct toward the formal institutional framework to support inflation targeting. The legal frameworks for all IT countries are defined that price stability and monetary stability is primary objective of the Central Bank; and ensure the independence of the instrument of the Central Bank. The emerging market countries often changed the legal framework of the Central Bank before applying inflation target, though, all emerging market countries clearly declare about limited funding of the Central Bank for budget deficit of government in primary market. Institutional framework being more formal for IT in emerging markets may reflect that inflation rates are much higher and more volatile than that of industrial countries, as well as reflect that financial systems are less developed and greater vulnerable with regard to inflationary monetization of government debt, and be more sensitive to exchange rate crisis.

- **The operating issues and the design of inflation targeting**: Central banks in the emerging market economies are less dependent on the statistical model in operating monetary policy. The emerging market economies often are much more intervenient in foreign exchange market because scope/ vision is shorter, and generally bring out target bands rather than point targets (target is an indicator). This difference reflects the structural differences with that of industrial countries. The emerging countries are easier to be vulnerable to shocks, especially the volatility of capital flows.
• The organizational aspects of the Central Bank: The majority of the Central Banks in emerging market made important organizational steps to strengthen their capacity to perform evaluation more, promote transparency and accountability.

• Issues of the transition to FFIT: In the transition to FFIT, several emerging market economies face the challenge of reducing inflation in the long-term inflation targeting. The experience of Chile, Israel, and Poland shows that gradual transition from crawling exchange rate mechanism to an inflation targeting framework is feasible with the support of the economic and financial policies in order to manage the transition and minimize the risk from cumulative responsibility on the Central Bank with conflicting goals.

Batini, Kuttner and Laxton (2005) argue that empirical experience shows no matter the different conditions have been satisfied or not, the application of IT at the beginning will less likely to have a good result. The authors assess the situation of the 21 countries applying IT; and 10 countries are based on the interview conducted by these countries’ central banks. The study brings out four groups of conditions: (i) infrastructure, (ii) health financing system, (iii) institutional independence, and (iv) economic structure. Specifically:

• Infrastructure: including the availability of figure/ data, systematic predictability, and ability to modeling the predicted conditions

• Health financing systems: including six standard indicators according to financial system of the United Kingdom: the legal capital such as % of risk assets, market capitalization securities, the depth of private bond market, the revenue of the stock market, the mismatch of monetary at local banks, and the duration of the bond which can exchange flexibly.

• The institutional independence: including indicators of financial responsibility in financing the budget deficit of the government; independence about instrument or complete independence about activity; although there is direction/ legal mandate or not, inflation are still focused; monitoring functions of Governor; favorable fiscal balance; low public debt; and a general measure of the independence of the Central Bank.

• Four indicators of economic structure: including economic conditions generally affecting the success of inflation targeting, which is: the transmission of monetary policy through the low
According to Charles Freedman and Inci Otker-Robe (2010), there are three core conditions to operate inflation targeting (IT), which are: inflation targeting being priority objectives of monetary policy, no fiscal dominance, and independent monetary policy instruments (the Central Bank is fully active in the use of monetary policy instruments). The majority of these conditions and other factors which are considered as fundamentals for inflation targeting framework can be established after making IT application. These conditions include the construction of formal models to forecast inflation, empirical research on the report release mechanism about monetary policy or reports about inflation, strengthening financial system through improving the supervisory regulation of financial institutions and encouraging the development of long-term bond market in currencies. Even if the ideal of economic environment and institution in emerging economies is not absolute from the beginning, the benefits of applying inflation targeting and the subsequent environmental improvement is significant; and this is the experience of industrial and emerging economies making IT application.

Gómez, Uribe and Vargas (2002) examined the implementation of inflation targeting in Colombia. Colombia began to implement inflation targeting in 1991 in which the Constitution as well as the Law tended to establish a legal framework which was consistent with the price stability objectives. With this legal framework, the Central Bank is significant independence while the objective of the Central Bank is price stability. Accordingly, the Central Bank has to publish its inflation target once a year, and required to submit a report to Congress twice a year. In general, in order to implement inflation targeting - a strategic framework of monetary policy, a number of minimum conditions that must be satisfied, which include: an independent central bank, a flexible exchange rate mechanism, accountability, and the quarterly inflation report explaining monetary policy decisions.

Jonas and Mishkin (2003) summed up the experience of inflation targeting in three countries with transition economies which are Czech Republic, Poland, and Hungary. In the second half of the 1990s, a number of transition countries abandoned a fixed exchange rate mechanism and switched to inflation targeting as a framework for the conduct of monetary policy. The authors pointed out
that these countries often deviate from the inflation target because transition economies are often subject to shocks and therefore mismatch from the inflation target occurs more frequent than that of developed economies. However, the disinflation is making good progress, and monetary policy strategy directing to inflation bring more benefits than the limitations.

According to Sherwin (2000), experience with inflation targeting has been 10 years and spent with different countries and different situation. It has been demonstrated that inflation targeting is an effective framework of monetary policy in which framework is particular suitable for small and open economies which have flexible exchange rates. The core feature of inflation targeting involves the public announcement of inflation target, recognition of low inflation and stable long-term of important monetary policy, transparency of the policy objectives, and the rationality for the monetary policy decisions and accountability for the achievement of policy objectives.

Mollick, Torres and Carneiro (2008) considered the impact of inflation targeting on output growth of the industrial and emerging economy in the period of 1986-2004 with a sample of 22 industrial countries and 33 emerging market countries. The authors use econometric instruments to examine this impact (the effects of economic openness and capital flow in/out are separated) and figured out that only full-fledged inflation targeting (FFIT) has long-term effect on growth.

Habermeier, et al (2009) said that one of the biggest challenges of emerging markets since inflation targeting is applied is the significant increase of food and gasoline price in mid-2007 and mid-2008. The increase of inflationary pressure is seen as a significant first test on the confidence of IT mechanism in emerging markets. The results show that the countries which have applied IT with floating exchange rate mechanism have inflation rates being less than that of those countries which don’t have IT application. There are no countries applying IT (except Turkey) which adjust inflation targeting that has been officially declared previously in the context of inflation increasing in order to avoid the collapse of confidence to the commitment of price stability and to reduce the risk of inflation expectation.

Charles Freedman and Inci Otker - Robe (2010) describes the experiences of a number of countries (Canada, Chile, Czech Republic, Hungary, Israel, Poland, Romania, and Turkey) in making the application, and implementing inflation targeting framework. The authors
summarize the reasons of the countries’ IT application; what results these countries applying IT has achieved when dealing with different situations; how these countries shift to full-fledged inflation targeting (FFIT), and the coordinated preparation of policy and economic reforms; the countries’ benefits derived from the IT application and the challenges faced in the implementation process; and lessons of the countries.

In summary, the international studies have analyzed adequately in both theory and reality of basic issues of inflation targeting framework. This is the fundamental basis for the Team to inherit and to study deeply about the applicability of the operating monetary policy framework of inflation targeting in Vietnam.

**Overview of domestic studies**

In our countries, there have been many scientific studies on monetary policy. The projects analyzed deeply on the aspects related monetary policy such as the relationship between monetary policies, macroeconomic policies, and the proposed solution to improve monetary policy (Duong Thu Huong, 2005); the relationship between the macro account, and construction and operation of monetary policy (Nguyen Thi Kim Thanh, 2004); operating monetary policy in the context of liberalization of capital transaction (Nguyen Ngoc Bao, 2008). Some projects studied about the use and improve of monetary policy instruments, and the effect of transmission mechanism of monetary policy (Nguyen Thi Kim Thanh, 2005, Tran Thi Loc, 2002) Tran Tho Dat, et al (2010), Ha Quynh Hoa (2008, 2010), Vo Tri Thanh (1996) examined the demand for money in making monetary policy in Vietnam. Meanwhile, a number of authors studied the money supply, the relationship between the payment balance and money supply in the State Bank of Vietnam (Nguyen Dong Tien, 2001). Several researches addressed the reform issues of the State Bank of Vietnam in order to enhance the independence of the Central Bank to implement monetary policy to be more effective (Vu Thi Lien, et al, 2007; Nguyen Dai Lai, 2005). Proposed solutions to improve the legal status of State Bank of Vietnam to become a modern central Bank (Vu The Vac, 2006).

However, there aren’t many researches on inflation targeting in Vietnam. There are a number of articles that mention to the monetary policy framework of inflation targeting, which analyze the
conditions that could be applied to the operating mechanism of monetary policy in Vietnam. Most of authors agreed that Vietnam has not yet applied the operating mechanism of monetary policy of full- fledged inflation targeting; however, there is a need of steps, roadmaps to prepare the conditions for the implementation of the monetary policy framework of inflation targeting (Nguyen Huu Nghia, 2005, Do Thi Duc Minh, 2005)

Phi Trong Hien (2005); Nguyen Van Tien and Vu Hoang Phuong Que (2005) studied and compared the experiences of application of inflation target of some countries (New Zealand, Canada) or the European Central Bank, and then provided some suggestions for Vietnam. According to the authors: (i) choice of inflation targeting policy must be based on the successful inflation period, (ii) the CPI and core inflation must be use in parallel to measure inflation, (iii) inflation targeting policy must be highly flexible, and (iv) inflation targeting policy not only have to ensure transparency and responsibility but also associate with the Central Bank.

In general, the articles about monetary policy targeting in Vietnam is only giving overview without explaining why it should or should not apply operating monetary policy framework of inflation targeting. In other words, these articles still have not provided profound and comprehensive assessment about applicability of inflation targeting in Vietnam as well as have not yet revealed the roadmap and solution to apply the inflation targeting in Vietnam.
CHAPTER 2

MONETARY POLICY AND THE COORDINATION FRAMEWORK FOR MONETARY POLICY TARGETING INFLATION

MONETARY POLICY AND ITS TARGETS

In macroeconomics, monetary policy is considered as a macroeconomic management tool implemented by the Central Bank. Monetary policy is the overall implementation of all measures, using the instruments by the Central Bank with a view to achieving the targets of the macroeconomic policy. This is undertaken through controlling, regulating the supply process of money and credit, which means through controlling cash in-flows and the amounts of money. Along with fiscal policy, monetary policy is adopted primarily to make an impact on the domestic sector (impacting internal balance), and afterwards affecting the external economic sector (affecting external balance). Despite differences among nations in making and managing their monetary policy, there are generally five steps in making a monetary policy such as: selecting the target system of monetary policy; determining the transmission mechanism of monetary policy; and selecting the monetary policy instruments to coordinate. This framework is always reviewed, adjusted to be suitable for the relentless fluctuations of the economic, financial environment.

A question raised is why is it necessary to select targets for monetary policy? The elaboration is approached based on the following perspectives. Firstly, the Central Bank cannot simultaneously achieve all its targets. Secondly, its operating environment pushes the Central Bank to set targets for itself. The environment is so large, but the following factors (advantages/disadvantages) will influence the Central Bank when it pursues its targets. They are: (i) The Central Bank’s extent of independence from the government; (ii) the extent and effectiveness of the cooperation between the macroeconomic policies of the economy, especially monetary policy and fiscal policy; and
(iii) the coordination capacity of the Central Bank. Thirdly, the changing economy also forces the Central Bank to modify its targets. The Central Bank should be persevering, adaptable and flexible to promptly take actions when the economic state faces big fluctuations, especially after its “shocks”. Of course, when the economic state falls into fluctuations, the changes to the Central Bank’s monetary policy are short-term. It can replace one target with another, yet obviously its long-term targets are unchanged.

How are the targets for monetary policy selected? Either coordinating a multiple-target monetary policy or coordinating a single-target monetary policy can be chosen. It can be said that coordinating a multiple-target monetary policy is the coordination in a conventional way. However, because of the significance level of each target to the mission and task in each specific phase, the target system of monetary policy is structured by the ultimate/primary target and others. The ultimate target can be either multiple or single. In many circumstances, due to pressure from political tasks, the Central Bank may pursue its ultimate multiple-target of low inflation and high economic growth. Certainly, an issue that needs explaining is that low inflation does not mean too low inflation, like 0%, for instance. Of course, if inflation is maintained at a too low rate, the risk of deflation will occur. Low inflation should be stable in order to stimulate investment and maintain economic growth. And high growth should be understood not too “hot” growth rate, but high and stable growth. The Central Bank of Vietnam implements a multiple-target monetary policy and has not specified any target to be ultimate. This issue will be mentioned and analyzed in a more detailed way in the later parts.

A single-target monetary policy is a monetary policy which pursues only a unique target, also the ultimate target. Compared with the coordination of a multiple-target monetary policy, that of a single-target monetary policy has some following superiority with a unique target. (i) The Central Bank will be able to select the most powerful and decisive instruments to influence and achieve its target; (ii) the measure for the effectiveness of the coordination of the monetary policy is clear and specific; and (iii) the unique target allows the professional apparatus of the Central Bank to more “wholeheartedly” do their job and then live up to expectations more easily.
The target system of a monetary policy consists of the ultimate target, intermediary targets and operating targets. For a modern Central Bank, a monetary policy includes the following targets: low and stable inflation, stable economic growth, creating employment, stabilizing the financial system, etc. The ultimate target is usually medium-term because of the late effects of the monetary policy on macroeconomic variables. A majority of countries select the ultimate target of stabilizing prices, maintaining low and stable inflation, based on which making contribution to economic growth and creating employment.

By employing monetary policy instruments, the Central Bank cannot directly and instantly exert an influence on the economy’s ultimate targets such as prices, output and employment. The effect of the monetary policy will only appear after a certain period of time, from 6 months to 2 years. It will be too late and ineffective if the Central Bank waits for the signs of prices and unemployment to adjust its instruments. To help with this limitation, the Central Bank frequently identifies the targets that need achieving prior to the ultimate target. These targets become intermediary and operating targets.

Intermediary targets are monetary variables that the Central Bank can measure precisely, and control promptly. Particularly, frequently selected intermediary targets are monetary variables that have close relation with macroeconomic variables such as GDP, prices, aggregate demand, etc. In other words, intermediary targets are closely associated with the ultimate target and have linkages with operating targets. The targets often regards as intermediary targets are the total amount of money supply (M2, or M3) or the market interest rate (short-term and long-term). Besides, the total amount of credit, and exchange rate are also the candidates for the role of intermediary targets. Particularly, (i) the intermediary target is the total amount of money: selecting a target level of monetary growth (MS or credit) that is suitable for the ultimate target. In case the intermediary target is the total amount of money, the reactions of the monetary policy are that interest rates falls when the increase level in money exceeds the target level and that interest rates go up when the increase level in money is less than the target level; (ii) the intermediary target is the market interest rate: the coordination of the monetary policy directs the market interest rate towards the target level. With this target, the monetary is aimed at mitigating the effect of the fluctuations of the money supply on the aggregate demand of the economy; (iii)
the intermediary is exchange rate: coordinating the monetary policy towards exchange rate stability. With this target, the monetary policy of the country selecting rate as its intermediary target rest on that of the country fixing the exchange rate. In summary, intermediary targets such as the total amount of money, the total amount of credit, exchange rate, or market interest rate which all have their particular pros and cons have been applied during the past decades. Each target is selected in association with the economic developments and the financial market in each phase, with targets, solutions to ensure macroeconomic stability. Nevertheless, the coordination of monetary policy cannot pursue two or three targets at the same time. To select suitable intermediary targets requires a careful analysis of economic and monetary developments in the present and in the forecast future, and the clear determination of both short-term and long-term directions for economic development.

Operating targets are monetary variables that the Central Bank can forecast and can affect or control more directly than intermediary targets through using monetary policy instruments to change intermediary targets, and thereafter affect the ultimate target of the monetary policy. Operating targets are divided into two types: (i) the performance target is monetary price: the Central Bank controls short-term interest rates in the interbank market. The Central Bank, through monetary policy instruments, can directly take control of this type of interest rate. In the event that the Central Bank chooses monetary price as its performance target, it means that temporary changes to the supply and demand of money are primarily aimed at obtaining the target of ensuring the short-term interest rate in the market do not go far from the target interest rate. Controlling interest rates will be effective under the condition that the monetary market grows, the interbank market has high liquidity and works effectively, the commercial bank system is competitive, the Central Bank earns high trust from its members in the market; (ii) the performance target is the amount of money: the Central Bank control money base (MB), or the components of MB such as international net reserves, the reserves of commercial banks, or domestic net assets on the balance sheet of the Central Bank. In case the Central Bank makes choice of the amount of money as its performance target, it does not regulate the changes to basic money demand and ignores the effects of interest rates but just give care to whether money base is suitable for its target or not. The target being the amount of money can be applied in case the
monetary market is inchoate, ineffective, the competitiveness among banks is low, especially in the context of high inflation.

To sum up, monetary policy can only be materialized when the Central Bank a proper target system for it. In each phase, targets are normally specifically quantified to be suitable for economic and monetary developments.

THE TRANSMISION MECHANISIM OF MONETARY POLICY

The monetary policy has an influence on economic behavior through different channels. To coordinate the monetary policy effectively, it is incredibly essential to conduct full research on these channels. Four channels through which the monetary policy affects economic sectors include: interest rate channel, credit channel, other assets’ prices channel and exchange rate channel.

Interest rate channel

When tight monetary policy (reducing money supply) is implemented, the demand for bonds will increase while that for money will decrease. If prices are not promptly adjusted, the real money supply will go down, increasing interest rates and capital costs. Investments fall, decreasing aggregate demand and output. This mechanism occurs inside the debt side of a bank’s asset statement. Economists have emphasized the role of interest rate in reacting to changes to monetary policy as well as in affecting physical economic activities. This mechanism is expressed as follows: tightening monetary policy => increasing interest rate => decreasing investment => reducing in output.

Credit channel

Credit channel is a group of factors enlarging and spreading the effects of interest rate. In other words, credit channel is a mechanism of reinforcement, not a completely independent channel or a parallel one with others. In nations with a private credit market that is undeveloped or under governmental intervention, the effects of the monetary policy on aggregate demand are greater
through changes to credit amounts than through interest rates. Once monetary conditions are
tightened, banks want not only to rely on raising interest rates to limit credit amounts but also
impose limitations on credit terms to prevent customers from investing in risky projects. This
reduces credit supply. In addition, monetary policy affects borrowers’ ability to access credit
sources. A borrower with an unhealthy financial state, low value of net asset, will suffer from
larger expenses and more difficult credit conditions. The changes to monetary policy will
influence borrowers’ financial state, hence affect their investment and expenditure decisions. A
tight monetary policy will directly affect a borrower’s asset statement through at least two
channels: (i) increasing interest rates directly raise borrowers’ interest costs, decrease net cash
flows, and worsen borrowers’ financial state; (ii) increasing interest rates reduce the prices of
property, including borrowers’ collateral. The tight monetary policy also indirectly affect
borrowers’ asset statement through worsening customers’ expenditure and reducing companies’
revenues.

Other assets’ prices channel

A tight monetary policy will reduce the prices of other main assets, such as shares, bonds, real
estate, etc., making households reduce their expectations of income and adjust their expenditure.
Besides, modifications to the monetary policy change the value of the assets that companies
possess, decrease companies’ market value, increase debt/asset ratio, and make it hard for
companies to pay their debts. Households and companies become more vulnerable than they
were to financial deteriorations. They try to recover their asset statement through cutting
expenditure and borrowing. Therefore, both consumption and investment go down and the final
consequence is that the economy’s output decreases.

Exchange rate channel

The monetary policy also influences the economy through exchange rate channel. In many
developing countries, especially those with rocky bond, stock, real estate markets, exchange rate
is the most important asset being affected by the monetary policy. When exchange rates are
floating, the tight monetary policy increases interest rates, raising the nominal value of domestic
currency. On the one hand, this reduces demand for domestic goods because they have now become rather much more expensive than foreign goods, and hence make reductions in aggregate demand. On the other hand, changing exchange rates have considerable effects on the asset statement as well. In small and open economies with flexible mechanisms, exchange rate is an incredible significant channel. Unlike the above channels, not only does it affect aggregate demand but also aggregate supply. With a fixed exchange rate mechanism, the effectiveness of a monetary policy will deteriorate. Normally countries maintain a wide amplitude of exchange rate fluctuations. Furthermore, if domestic and foreign assets cannot be completely interchangeable, there are still gaps between domestic and international interest rates. Thus, even if nominal exchange rates are fixed, the monetary policy can still influence real exchange rates through prices. This mechanism can be expressed by the following chain: tight monetary policy \( \text{\(\leadsto\)} \) increases in the prices of domestic currency, decreases in exports, increases in imports, decreases in net exports \( \text{\(\leadsto\)} \) decreases in output.

**CONDITIONS FOR THE EFFECTIVE ADOPTION OF MONETARY POLICY**

A monetary policy framework of any Central Bank has all of the factors such as monetary policy instruments, operating targets, intermediary targets, ultimate targets and performance strategies. So as for these factors to develop the best when employed, the coordination of monetary policy needs some following conditions:

- The Central Bank’s independence, responsibility and transparency in coordinating its monetary policy;
- The suitability about the targets and measures of macroeconomic policies is an important condition to ensure the effectiveness of making and implementing the monetary policy;
- The development of financial institutions and the monetary market.
In summary, to coordinate the monetary policy effectively, in addition to the Central Bank’s building up a monetary policy framework which is suitable for the state of the economy, that the above conditions are satisfied will be a solid base to ensure the success of the monetary policy in pursuing its set targets. The Central Bank’s independence, responsibility and transparency in coordinating its monetary policy ensure the trust of the financial market members in the Central Bank’s implementation of its monetary policy. The suitability about the targets and measures of macroeconomic policies ensures the effectiveness of the targets that the monetary policy pursues, and the development of financial institutions and the monetary market is a positive supporting condition for the success of making and implementing the monetary policy.

MONETARY POLICY FRAMEWORKS IN THE ECONOMIC HISTORY

What is the best monetary policy framework for Vietnam? To find out a measure for this issue, we can learn quite a lot from the history of the economy and other nations’ experience. Thus, this research primarily focuses on the history of the global monetary policy during the past 50 years, looks at the development and draws a conclusion about a particular field. The report mentions basic issues of the framework for the policy of targeting inflation. It also studies countries’ experience in applying the framework for the policy of targeting inflation. Secondly the research considers the factors affecting the economic state in Vietnam and their effects on the macroeconomic policy and especially the monetary policy. The report deeply analyzes the framework for the current monetary policy of Vietnam and raised issues. Then the research lists the reasons why the monetary policy should be oriented towards the target of stabilizing domestic prices to ensure economic growth, sustainability and prepare necessary conditions towards applying the framework of targeting inflation in Vietnam in the long run.

Select a better “anchor” for the monetary policy

In order to coordinate its monetary policy effectively and help the economy operate well, the Central Bank should select a nominal anchor for its monetary policy. So as to understand the
way to select a better “anchor” for the monetary policy, we should look over this process under the historical perspective.

The “fixed exchange rate” period

Previously, the most common nominal anchor was the one that fixed the value of domestic currency with gold (under gold standard regime) or with some strong currency or a basket of foreign currencies. During the 1950s and 1960s, most Central Bank Acts provided that the primary target of the monetary policy was to stabilize the external value of currency – or exchange rate. At that time, the world was applying the fixed exchange regime and the monetary had to resist pressure from exchange rate. Stabilizing prices was just the second target. As regards the economic history of England and other European nations, this period witnessed quite a lot of serious crises of the balance of payments, pushing authorities to periodically loose or tighten their nations’ macroeconomic policies. For further understanding of this issue, the research will analyze the operation mechanism of the monetary in that context. Let’s start with the balance in the balance of payments. If a nation has a significantly surplus trade balance, or a large source of capital as a result of increases in direct or indirect investment, exchange rates are likely to go up thereafter. In this system, the Central Bank has no other choice but implementing non-sterilized interventions in the market. The interventions are purchasing foreign currencies, leading to increased foreign exchange reserves and making payments in domestic currency without any measures for preventing the consequence of increased money supply. The rate of economic growth will go up, and if the economy is operating close to the maximum level, prices and salary are likely to soar right then. Thereafter, this nation will lose its competitiveness as the domestic currency is assessed too high in comparison with foreign currencies. Exports will go down, and the trade balance will decline. Unless a large source of investment capital flows into that nation, exchange rates will be at risk of changes. In case exchange rates are at risk of decline, the Central Bank will sell dollars to the market and receive domestic currency. This will cause money supply to decrease, and hence, push interest rates to climb, slowing down the process of economic growth.
In an open economy and in a circumstance like that, when prospects play a very big role, and when there are not or few measures for controlling exchange rates, a large amount capital flowing out of a nation will make the crisis of the balance of payments more serious. The sources of capital will be withdrawn very quickly and this can turn the state serious within just a few days. Then, authorities will have to immediately apply the policies that are unlikely to create serious consequences for the economy.

Historical experience shows that if it follows the above model, the period of economic expansion will become quite a lot shorter (on average equaling one-third or half) than the following period of shrinking economy. This is easy to understand since prices and salary are more likely to go up than to go down. Laborers will react aggressively to the fact that their salary is cut and will only accept to compromise if the economy is in prolonged and serious recession. In England, this led to prolonged economic instability and an ineffective economy. This policy was named “stop-go policy”, more vividly described with the image of a driver with one foot on the brake and the other foot on the accelerator. The rate of economic growth was low and enterprises did not invest in machinery and equipment, and as a consequence, production deteriorated. This caused many serious strikes and social intensity. Finally, pound sterling was forced to be devalued. The same state occurred in France and other European nations. This period was characterized by several crises of the balance of payments and that nations were forced to devalue their currencies.

All in all, coordinating the monetary policy under the fixed exchange rate regime showed such drawbacks as: (i) countries cannot be independent in their monetary policy because the exchange rate is closely attached to a strong foreign currency. The up/down of the strong foreign currency forces the nations applying the anchor exchange rate regime to this currency to adjust their monetary policy. Specifically, in an open economy under the fixed exchange rate regime, the Central Bank should intervene once the balance of payments is surplus or deficient. It’s because the surplus balance of payments (foreign currency in-flows larger than out-flows) will make supply in the foreign currency market surplus, resulting in an increased price of domestic currency, a devaluation of foreign currency (changes to exchange rate). The Central Bank will have to intervene through purchasing foreign currency and selling domestic currency. Thus, the changed amount of domestic reserve currency equals the amount of foreign currency purchased.
and therefore, affects total means of payment. Under the condition of fixed exchange rate, the monetary policy is always passive and finds it hard to pursue its targets; (ii) to anchor exchange rate requires the Central Bank to possess international reserves at the level that it can actively intervene the market.

*The “money supply” period*

During two or three first decades after World War II, Bretton Woods system collapsed and the world’s inflation rate strongly increased in the early 70s of the 20th century, leading a number of industrialized countries to look for a nominal anchor for replacement. In the late 70s and early 80s, the world shifted to a more flexible exchange rate regime. The industrialized countries shifted from the mechanism of coordinating their monetary policy anchored with exchange rate to that of controlling the amount of money supply.

Selecting the target of money supply as an anchor for the monetary policy had an advantage (compared to an anchor for exchange rate) that was higher independence for the Central Bank in coordinating its monetary policy. In addition, not needing to focus much on intervening exchange rate (floating exchange rate), the Central Bank got an opportunity to more “wholeheartedly” control money supply. Many nations tried to anchor their monetary policies with M2 or M3 in the hope that controlling the speed of increasing money supply would allow the Central Bank to reduce inflation rate and maintain it at a low rate. However, anchoring the monetary policy in the target of money base was not really successful due to several reasons. One of the most important reasons was the instability in money demand function. This instability primarily resulted from the combination of deregulation in some nations and banks and other institutions’ wave of financial innovation which led to significant changes to the way people hold their financial assets. These changes affected measuring the total amount of money supply.

The monetary anchored by the target of money supply in fact showed a lot of limitations as follows: (i) the process of coordinating the monetary policy did not help clearly assess the interaction between the expenditure for money supply and that for inflation. One nation ensured its expenditure for money supply but its inflation rate was still high, whilst another’s deflation
still recovered slowly despite “excessively” pumping money. (ii) the issue that the people were directly concerned about and required from the Central Bank was stabilizing prices through a stable low inflation rate, rather than M1, M2 or M3. Thus, under the condition that inflation was not controlled to ensure stable prices, it was difficult for the Central Bank to convince the public that it had done its assigned task well; and (iii) one of the significant conditions for controlling money supply is that the Central Bank should control the supply of the total means of payments for the economy. In such an economy, typically Vietnam, when a rather large number of intermediary financial organizations (Vietnam State Treasury, Bank for investment, insurance companies, etc.) was operating out of the regulation of banking law, it was obvious that the Central Bank could not control the expenditure for money supply effectively.

*The “target of inflation” period*

In order to resist inflation pressure and expectations which were aggressively occurring after inflation rate had climbed in the 80s and early 90s of the 20th century, developed countries resorted to tightening their monetary policy considerably, with very high nominal interest rates. This resulted in serious depression, together with social intensity in the 80s and early 90s. As to the 1980s, the total amount of money as a nominal anchor for the Central Bank’s monetary policy obviously failed. Some nations having applied the mechanism of floating exchange rate before could not use conventional nominal anchors for the monetary policy such as fixed exchange rate or total money supply.

The Central Banks in these nations only qualitatively made commitments for the target of low inflation rate in coordinating their monetary policy. Yet, these nations normally had a history of high and erratic inflation. The so-called qualitative commitments were not enough to convince the public that the Central Bank had truly promised to take necessary actions to reduce inflation rate and maintain it at a low rate.

As the inevitable of the development process, with a view to looking for a better anchor for the monetary policy, in the late 80s of the 20th century, starting with New Zealand (July 1989), and then one after another Canada (December 1991), England (October 1992), Sweden (January
1993), Finland (February 1993), Australia (April 1993), Spain (November 1994), etc. selected targeting inflation as an anchor for their monetary policy. Currently, no industrialized country is employing total money supply as an anchor for the monetary policy and there is little likelihood that this state will change in the future. Most industrialized economies have got a flexible exchange rate mechanism or work as part of a monetary union where the Central Bank of the union (European Central Bank) floats currency. Many nations used the monetary policy framework of targeting inflation. Some others, such as the United States or Japan, promised low inflation rates but used a qualitative approach and failed to set a clearly quantitative target for inflation rate. The picture in emerging countries was more diverse. Some countries still used total money supply as a policy anchor. Some others used the anchor of exchange rate. Some emerging economies, typically medium-sized or larger ones, implemented the monetary policy framework of targeting inflation and are now using targeting inflation as their nominal anchor7.

To sum up, in the practical coordination of their monetary policy, the Central Banks try to establish themselves a proper framework for the monetary policy. Accordingly, targets, instruments and the transmission mechanism of the monetary policy are clearly determined to be suitably directed towards the coordinating activities of the Central Bank. There are so many coordination mechanisms established by the Central Bank resting on each nation’s condition. It is very difficult to assess this mechanism as superior to that one. Why does this nation select economic growth as the target of its monetary policy with “the anchor” of exchange rate and succeed in it, while the same mechanism makes another Central Bank end in failure? Even inside a country, there is no coordination mechanism of monetary policy that is suitable and optimal for all circumstances. Changes in operating environment, institutional structure and the structure of the economy, even economic environment, and international finance create new challenges and pressure promoting the Central Bank to look for the more suitability for the coordinating

7Emerging economies applying the monetary policy framework of targeting inflation: Israel (June 1997); Czech Republic (December 1997); Poland (March 1999); Brazil (June 1999); Chile (September 1999); South Africa (February 2000) etc.
mechanism of the monetary policy in order to contribute to ensuring the economy long-term sustainable development.

The history of economies and the experience of nations show that looking for a better coordinating mechanism for monetary policy results in applying the model of coordinating the targeting inflation policy. For the final target is to maintain a regularly low inflation rate to maximized the real speed of economic growth, monetary authorities realize that this model outperforms others. And reality shows that, generally in the past decade, the nations applying the mechanism of targeting inflation have been able to maintain a relatively low and stable inflation rate, with higher economic growth rate, unemployment rate declining and people’s living standards being remarkably improved. We will analyze these issues more deeply in the upcoming content.

WHY DOES A NATION NEED TO MAINTAIN A STABLE LOW INFLATION RATE?

Many studies have shown that an economy will operate better, in terms of real GDP growth, employment and improvement in people’s lives, if its inflation rate is low and stably maintained at that level. It’s because inflation expectations will make economic entities’ behavior unstable. It can be said that every abnormal and improper behavior of inflation indexes leave behind negative consequences for the economy. Inflation means money is devalued, which is bad news for most people. Inflation distorts prices, devalues savings, discourages investment, triggers shifting capital into foreign currency assets, investment in precious metals and real estate, hampers economic growth and the climax is it can lead to social and political instability.

While a high inflation rate\(^8\) is a “nightmare”, deflation is an “obsession” for governments. According to the definition by IMF, deflation is the prolonged decline in general price indexes such as consumer price index or GDP deflator. Almost a regular phenomenon (China is an

\(^8\)Which inflation rate been considered high is a controversial question. Most researchers agree that prolonged double-digit inflation (10% or more) is not good for growth.
exception), great deflation is followed by economic recession or stagnation, making aggregate demand, especially consumption (C) and investment (I) to decline. Deflation increases the value of nominal debts and if excessively can lead to insolvency or the debtor’s bankruptcy, and consequently does harm to the economy. An ominous thing is that deflation reduces the effectiveness of the monetary policy for the ability to transmit the effects of the monetary policy through the channel of real interest rate goes down not only when the real interest rate decreases to 0 and inflation is negative. Therefore, how to maintain and control inflation at a suitable level becomes the central problem, the ultimate target of the monetary policy to promote the effect of “lubrication” and reduce the effect of “resistance” of inflation. This issue is pretty controversial among economists. One of the philosophical issues or the mainstream principle of selecting inflation as the target of the monetary policy is the inverse relationship between economic growth and inflation. If it ensures monetary stability and maintains inflation at a proper level (low inflation within a certain estimated amplitude), the monetary policy will contribute to well implementing the target of economic growth at least in a short-term period, even to ensuring the target of stabilizing exchange rate and the safety of the bank system. Besides, practical experience demonstrates that coordinating the monetary policy in a short-term period in order to achieve other targets like reducing unemployment rate or increasing GDP can conflict with the target of stabilizing prices. It seems that the Central Banks have been criticized by the public for raising their interest rates (one of the common tricks to fight inflation) more than lowering interest rates. On the other hand, the Central Bank always suffers from pressure to stimulate economic activities. In principle, selecting inflation as the target will help resolve this asymmetric issue by choosing inflation instead of GDP or unemployment rate as the ultimate target of the monetary policy.

PRIMARY ISSUES ABOUT THE MONETARY POLICY FRAMEWORK OF TARGETING INFLATION

Definition, concept of the monetary policy framework of targeting inflation
Until now there have been nearly 30 nations and many others in the upcoming time which apply the coordinating mechanism of the monetary policy of targeting inflation, but it can be said that this mechanism has been still quite new. Both the principle and practice of this mechanism are being interested by theorists and macro managers who study them and accumulate experience.

International Monetary Foundation (IMF) defines: “The monetary policy of targeting inflation is an announcement to the public about the medium term target of inflation as well as the credibility of monetary authorities to achieve this target. Other elements include informing the public and market of monetary policy makers’ plans and targets, together with the Central Bank’s accountability to obtain its inflation targets. Decisions on the monetary policy will be based on the deviation of inflation forecasts (completely or obviously) as an intermediary target of the monetary policy.” Overall, the inner part of the monetary policy of targeting inflation includes such elements as: (i) about information, it is a widespread, public announcement to the public and market about the estimated inflation target in the authority’s plan year. Normally, that target lies within a certain amplitude range; (ii) about responsibility, when the inflation target is announced by the authority, it means the Central Bank is appointed to the top responsibility to implement that target which is the only target for it. In order to implement the inflation target, the Central Bank has the right to flexibly choose plans, instruments and should be accountable for their use of them to the public and market; (iii) technically, once the target of inflation is employed as the target of the monetary policy, one requirement raised is that monetary policy makers choose a way to determine the inflation target so as to ensure the elimination of non-monetary inflation at a max level. In addition, on the basis of adequate parameters to develop a plan, impact instruments are used to implement the inflation target optimally; and (iv) from the perspective of effectiveness assessment, the attainment level of targeting inflation is the most obvious and reliable proof of the Central Bank’s credibility.

Despite different understandings about the monetary policy framework of targeting inflation, it can be generalized that selecting inflation as the target of the monetary policy is the framework for coordinating and assessing the monetary with 4 following main elements: (i) price stabilization or inflation is the primary or unique target of the monetary policy. These targets must clearly show the public that the target of inflation gets more priority than other targets of
the monetary policy; (ii) targeting inflation is clearly quantitatively determined with a number or a determined range of values. The Central Bank needs to establish a model or measure forecasting inflation through making use of a number of indexes that contain information about future inflation; (iii) implementation roadmap – the period of time to achieve inflation targets; and (iv) the assessment of the Central Bank’s implementation of the inflation target – characteristically reflecting greater transparency in the monetary policy.

With such an approach, the Central Bank forecasts the roadmap of future inflation, which is compared to the target inflation that the government considers suitable for the economy. The difference between forecast inflation and target inflation will determine the adjustment level of the monetary policy. According to this approach, choosing inflation as the target of the monetary policy is really the coordinating and assessing framework for the monetary policy, not simply just selecting the ultimate target (inflation). Therefore, people emphasize the incredible important role of inflation forecast since it determines how the monetary policy should react.

**Characteristics of the coordinating mechanism of the monetary policy of targeting inflation**

In comparison with the previous mechanism, the monetary policy of targeting inflation has some main advantages such as: (i) allowing establishing a transparent framework for the monetary policy with the Central Bank’s accountability and credibility assurance to the public. That is the basis to determine the public’s faith in the monetary authority and is the mechanism to assess the Central Bank’s level to fulfill its mission; (ii) this is a coordinating mechanism of the monetary policy which creates both necessary concentration for the Central Bank and freedom, flexibility and certain autonomy in coordinating its monetary policy; (iii) the relative independence of the Central Bank is maintained, so it can deal effectively with domestic shocks as well as protect the economy against external shocks; and (iv) directed at a single target of inflation, the monetary policy of targeting inflation has laid foundation for other macroeconomic targets such as growth, employment, etc. to develop stably in the long-term period. This will be proved more clearly on approaching the economies which have applied the coordinating mechanism of the monetary policy of targeting inflation. However, in spite of many strong points, this mechanism is not the useful cure for all types of diseases.
The above strong points of the coordinating mechanism of the monetary policy of targeting inflation are also its own weaknesses. First, because of the binding mechanism between rights and responsibilities in coordinating the monetary policy of targeting inflation, the Central Bank itself may pay very dear prices if its own decisions in coordinating the monetary policy lead to a high inflation rate instead of a low and stable one. Secondly, due to the effects of the policy on inflation has time lapse, the Central Bank cannot easily control inflation. Thus, timely attaining the inflation target often meets difficulties and thereby assessing the success level of the policy is also late. Thirdly, trying to achieve targeting inflation can lead to the unstable growth rate of employment and output. Fourthly, due to the binding mechanism between the Central Bank and the public, the former always faces pressure to be more transparent, communicative while it cannot meet this requirement all the time.

In general, the common characteristics of a mechanism of targeting inflation can be described as follows: targeting inflation can be described as a coordinating mechanism of the monetary policy based on using inflation forecast as an intermediary index of target. The Central Bank will forecast the next year’s inflation trend to orient the index of target inflation with a number or an amplitude range for the plan year without any responsibility to implement any other target. Within its limitations, the Central Bank can flexibly select and use instruments to reach a single target – that is the index of target inflation.

Nevertheless, a shortcoming of the mechanism of targeting inflation is when the regulating capacity of the monetary policy is not high, the Central Bank will be thrown into a vicious cycle of deciding on priority among the mechanisms (exchange rate, interest rate and amount of money) of the monetary policy. Furthermore, applying targeting inflation, the Central Bank will hold responsible officially and unconditionally upon implementing its monetary policy to achieve the target index based on the inflation forecast index given by the Central Bank. Then, inflation forecast is considered the intermediary target of the monetary policy, so quite a lot of people have not mentioned targeting inflation but just targeting inflation forecast.

One more difference between the coordinating mechanism of the monetary policy of targeting inflation and other mechanisms is that it brings the Central Bank freedom and flexibility in
coordinating the monetary policy, determining the range of targeting inflation (an index or an amplitude range). Yet, in order to apply targeting inflation, the Central Bank, firstly, should get high trust from the society and operate transparently. Furthermore, the experience of the countries applying targeting inflation indicates the necessity of building up the prerequisites to apply targeting inflation in coordinating the monetary policy. Above all, targeting inflation can only be applied in the countries which are able to guarantee to maintain inflation at a low rate not only in form but in reality. Monetary managing authorities are aware that with monetary support, expanding budgets not only fails to promote economic sectors, but monetizing budget deficits is also the direct foundation for price increases in the economy, damaging the stability of the financial sector and degrading long-term economic growth.

**Primary pillars of the monetary policy of targeting inflation**

The monetary policy of targeting inflation has some primary pillars without any of which it will become ineffective.

*Transparency*

There are two factors behind the reinforcement of the Central Bank’s transparency. The first one is the relationship between the transparency and effectiveness of the monetary policy. The other is the relationship between the transparency and accountability of the Central Bank.

The transparency of the monetary policy requires the Central Bank to be transparent in the target of the policy, in the operation of the monetary transmission mechanism between the Central Bank’s policy actions and target variables, in assessing the prospects of economic activities and inflation from the viewpoint of the Central Bank and in establishing the policy interest rate. In general, transparency will help improve the function of the monetary policy in some following perspectives:

Firstly, transparency broadens the public’s awareness of the market and the monetary and the monetary will benefit from the public’s awareness and support. For instance, to reduce real estate bubble or “cool” the economy currently too hot, a tight monetary policy is necessary, but this
will lead to a trade-off between inflation and growth. The Central Bank should highlight that the role of the monetary policy is to curb long-term inflation and assert that a low-inflation environment will help the economy to attain a higher productivity growth rate. If the public discover and trust the target that the Central Bank is aiming at, the expected inflation rate will go down and thereby reduce the cost of curbing inflation.

Secondly, the relationship between the transparency and function of the monetary policy includes the behaviour of the parties in the financial market. When the financial market understands and foresees the Central Bank’s behaviour, the first steps in the monetary transmission mechanism between policy actions and economic activities as well as inflation will be implemented more smoothly.

Communication strategy

The media plays an important role in conveying the Central Bank’s stand to the market and the public. Some messages that the Central Bank needs to communicate include: (i) the Central Bank should assert that the target of low and stable inflation rate is the means to reach the ultimate target for the economy’s healthy growth. Only then are jobs offered more and people’s living standards improved in a stable environment; (ii) the Central Bank should assert that the monetary policy is a fundamental but inadequate means to attain economic targets. For example, the Central Bank should clearly inform the public that its healthy fiscal policy is essential for the effective coordination of the monetary policy and that structural policies and the measures for liberalizing the economy are really significant to economic growth.

When introducing the framework for the monetary policy of targeting inflation, the Central Bank should try to clearly convey the public and market the way this framework is coordinated. This means the Central Bank provides discussions about the target of the policy, its current awareness of the transmission mechanism of the monetary policy, and explains the main design parameters of the mechanism of targeting inflation. Among the most important perspectives of the communication strategy is providing a clear explanation about the way the Central Bank will react to the effect of supply-demand shocks on forecast inflation. The Central Bank needs to
underscore: (i) the Central Bank’s approach to the policy will focus on medium term; (ii) the forecast inflation rate will play an important part in coordinating the policy; and (iii) the Central Bank’s stand on forecast inflation will vary when it gets new information (including unpredictable shocks) and when there are changes to economic development.

*Information disclosure*

The transparency in coordinating the monetary policy is determined based on the Central Bank’s level of information disclosure to the market.

Basically, the sorts of information that the Central Banks normally disclose in order to make the coordination of the monetary policy transparent, include: (i) the target of the coordination (inflation rate, or money supply, or exchange rate that the monetary policy is supposed to achieve); (ii) forecasts for macroeconomic, financial, monetary targets and the possibility of attaining; (iii) the minutes of the meetings and policy; (iv) the result of the poll for policy decisions; and (v) explanations about changes to the policy.

Methods of information disclosure include: (i) press release, press briefing: often conducted right after meetings, briefly explaining the reasons for making policy decisions; (ii) reports: monthly, quarterly, annually made, being detailed analyses of the context and macroeconomic prospects through each period, the process and the result of coordinating the monetary policy in relationship to other macroeconomic policies, the upcoming policy decisions; (iii) organizing official or unusual meetings; and (iv) the speeches and announcements of the Central Bank’s leaders and experts.

*Accountability*

The second factor promoting the trend towards greater transparency is the tendency towards greater accountability, a significant factor in the framework of supporting the Central Bank’s independence. So as for accountability to be effective, the supervising authority should get enough information to assess the Central Bank’s policy coordination. The Central Banks provide that information in their content of comprehensive communication strategy, and the demand for
the disclosure of this information plays an increasingly important role in the transparency of the monetary policy.

**Basic conditions for the Central Bank to apply the coordinating mechanism of the monetary policy of targeting inflation**

First, the Central Bank needs to have a relative independence level to implement its monetary policy though no Central Bank can be absolutely independent from governmental. It needs to, within limitations, freely select instruments to achieve its target inflation rate. In order to meet this requirement, that nation needs to get rid of the principle “governing budgets”, as well as that issues belonging to the fiscal policy must not exert any influence on the monetary policy.

Second, the Central Bank should have the capacity to implement targeting inflation as well as fails to hold responsible for other targets such as: salary, unemployment rate or exchange rate.

Third, fiscal and financial institutions should be healthy. A healthy fiscal institution is expressed in the balance between the collection and expenditure of the policy, clear discipline in collecting and expending activities, without any intervention so that the Central Bank finances budget deficits or release money in order for the government to pay debts. A healthy financial institution is expressed in the sustainable development of the bank system and the system of non-banking financial institutions.

Fourth, monetary institutions should be strong. There must be widespread institutional compromises on price stabilization which should be understood as the most important target of the monetary policy in the long-term period.

**Principles of the monetary policy of targeting inflation**

The principles of the monetary policy of targeting inflation include:

Principle 1. The primary role of the monetary policy is to provide a nominal anchor for the economy and set other targets that must not be incompatible with the anchor of the monetary policy. With this principle, the Central Bank needs to clearly state that the monetary policy is
aimed at pursuing just a single nominal anchor of inflation, and unable to pursue a real target like economic growth or employment. Setting both a target of low inflation rate and that of high economic growth rate will make the public and market no longer trust monetary policy which selects inflation as its target. Furthermore, it is challenging for the Central Bank to pursue both these targets with a trade-off at the same.

Principle 2. An effective mechanism for the monetary policy of targeting inflation will have a favorable effect on the benefits of the economy from reducing uncertainties, shaping inflation expectations and reducing the incidence and severity of the boom – crash cycle.

Principle 3. The success of a mechanism of targeting inflation rests on other policies, which should make the responsibility of the monetary policy easier and more reliable. For instance, when the budget deficit is large and the risk of inability to pay debts comes up, offsetting the deficit by means of debt issuance becomes difficult. Thereafter, even though a monetary policy is oriented towards the target of inflation, the public and market will expect a fiscal policy financed by “monetization”, leading to increased inflation expectations and affecting real inflation.

Principle 4. Due to the time lag in the monetary transmission mechanism and even the fact of not achieving the set target of inflation and the gap between real output and potential output, there is neither likelihood nor satisfaction to maintain inflation exactly at the target rate. This principle shows that the Central Bank should not try to coordinate its monetary policy so that the real inflation is the same as the target one. The cost of this effort will be extremely high despite making the real inflation rate close to the target rate. With this principle, the Central Bank needs to set a range around the central inflation that should be neither too narrow for the target to be reached regularly, nor too wide with a view to always achieving the set target.

Principle 5. Given the possibility of contraries/conflicts between the target of inflation and others, the Central Bank should set clear, proper and adequately independent targets in order to achieve its planned targets. To implement this principle many countries have added to their law the provisions to increase the Central Bank’s independence, or appointed their Bank Governors for longer terms which are not parallel with those of the President/Prime Minister.
Principle 6. There should be effective mechanisms to supervise and explain to make sure the Central Bank is taking actions compatible with its announced targets and the monetary policy should be based on sound practices. This principle can be applied through the supervision from the National Assembly or the government. With the framework for the monetary policy which selects inflation as the target, the target of inflation is clearly quantified, thereby making it easy for the authorities to supervise and for the Central Bank to provide explanations.
CHAPTER 3

EXPERIENCE OF SOME COUNTRIES IN THE APPLICATION OF INFLATION TARGETING MONETARY POLICY FRAMEWORK

Since New Zealand adopted an inflation targeting monetary policy in 1989, there were nearly 30 countries applying the administration framework of the monetary policy which took inflation as a target. Moreover, a number of other Central Banks, including the Europe Central Bank (ECB), the Swiss National Bank and Federal Reserve System (FED) have applied some mechanisms which have many attributes of inflation targeting monetary policy. Whereas inflation targeting almost occurred entirely in some advanced and “industrialized” countries in the early 1990s, emerging and developing countries adopted inflation targeting monetary policy framework increasingly since the late 1990s. And now, these countries are majority in the ones applying inflation targeting framework. The adoption of inflation targeting is often promoted by exchange rate crisis. As of 1989, there were about 2/3 of the industrialized countries which have a monetary policy regime anchor exchange rate. Exchange Rate Mechanism crisis (ERM) of the European Monetary System (EMS) in 1992 was the driving force for the adoption of inflation targeting in Europe. In emerging economies, the process of implementing inflation targeting (IT) takes place at a slower speed. In Latin America, the movement of transition to inflation targeting started from the early 1990s. However, full-fledged inflation targeting framework (full-fledged IT) only was adopted since the late 1990s and early 2000s. In Europe, the transition economies in Central and Eastern Europe began the adoption of inflation targeting mechanism in the late 1990s as a part in overall economic reform program in these countries. Meanwhile, in South-East Asian, inflation targeting was introduced to adopt in the early 2000s under the impact of the Asian financial crisis in 1997. Before the global financial crisis, inflation targeting mechanism was expected to spread in emerging and developing countries.9 Prospect for implementation of

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9The discussion between IMF and member countries in 2006 showed that the number of inflation targeting implementation in emerging economies and developing countries can increase 4 times over the
inflation targeting monetary policy now seems to depend heavily in how the IT framework resolves oil price shock and the result of the global financial crisis. In short, the inflation targeting has confirmed some certain advantages, the popularity and the suitability in the different level of development. The approach using inflation as a monetary policy target is gradually becoming a major trend in the region and the world. Before that, the experience and the convenience in the administration made most Central Banks implement monetary policy based on intermediate targets such as amount of money, interest rates or exchange rates. This new approach using inflation as a monetary policy target has broken the traditional mechanism of monetary policy administration and primarily concentrated on inflation rate as a sole and direct target of the monetary policy. Up to now, there has been little experimental evidence supporting that small and vulnerable economies do not guarantee the successful implementation of inflation targeting monetary policy. On the other hand, there has been no evidence to support that using inflation as a monetary policy target could distort policy priorities in the direction focusing efforts on the inflation solution of Central Bank caused the distraction of the common goal of economic development. In the following section, we deeply analyses about: (i) Reasons for adopting inflation targeting monetary policy; (ii) Effect of the implementation of inflation targeting monetary policy compares to the others monetary mechanism (macroeconomic results, the ability to respond to the crisis), and (iii) lessons learned in the implementation of inflation targeting monetary policy in some countries in the world.

**REASONS FOR ADOPTING THE ADMINISTRATION FRAMEWORK OF INFLATION TARGETING MONETARY POLICY**

It can be said that reason for adopting inflation targeting monetary policy in many countries is diverse extremely. Most countries move to apply inflation targeting monetary policy due to the instability of exchange rate; thus, they require the nominal anchor for inflation expectations.

next decade. This is consistent with predictions of Husain Mody and Rogoff (2005) when they suggest that the number of countries anchoring exchange rate almost will halve in the next 10-15 years.
Besides, some countries apply IT in response to poor economic activity; a number of other countries, in order to meet the requirements to join the European Union. (see Table 3.1 below).

### Table 3.1 The motivation of inflation targeting application

<table>
<thead>
<tr>
<th>IT countries</th>
<th>Response to poor economic activity</th>
<th>The instability of exchange rate</th>
<th>Participate in EMU</th>
<th>Anchor inflation expectations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>x</td>
<td></td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Chile</td>
<td>x</td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>x</td>
<td>x</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Israel</td>
<td></td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>Polish</td>
<td>x</td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>South Africa</td>
<td>x</td>
<td></td>
<td>x</td>
<td>X</td>
</tr>
<tr>
<td>Australia</td>
<td>x</td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>Canada</td>
<td></td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>Finland</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New Zealand</td>
<td>X</td>
<td>x</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Spain</td>
<td>x</td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Sweden</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United Kingdom</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Bernanke and his colleagues (1999), Morandé and Schmidt-Hebbel (2000), Clinton (2000), and the reports of Central Bank.

In general, reasons for IT adoption in the countries can be divided into two groups as follows:

Firstly, the group expects a new more effective monetary policy. The reality points out common reason for many countries implementing inflation targeting is that these countries have difficulties in using of the other nominal anchors (such as the exchange rate or the money
supply), as well as desire to lower inflation and anchor inflation expectations. The majority in this group is industrialized countries such as New Zealand, United Kingdom, Canada and other transition countries such as the Czech Republic, Poland, Hungary and etc.

Secondly, the group has the reason of the shock currency - financial crisis or being affected of the earlier currency - financial crisis. Most developing countries adopting inflation targeting monetary policy are in this group. A typically country establishes inflation targeting monetary policy in response to the monetary shock is Brazil. In 6/1999, Brazil officially adopted mechanism of inflation targeting monetary policy. However, the application of this currency mechanism is considered as a policy to cope with the previous collapse of the Real in 1/1999. Meanwhile, in other countries such as Mexico, South Africa, Thailand, Korea, Philippines, Indonesia and so on, the application inflation targeting monetary policy does not start from the direct economic shock, but before that, these countries has experienced or affected by the currency - financial crisis. The main purpose of IT application of these countries as well as many industrialized countries such as Sweden, and the UK is that they need a new anchor for currency policy after cancelling the fixed exchange-rate regime.

Although the reason each country moves to the administration mechanism of inflation targeting monetary policy can be different, basing on the rationale, these countries all agree that: (i) the low and stable inflation rate and will contribute to promote economic growth and increase employment rate in long-term, (ii) taking low and stable inflation target as the sole aim helped overcome the phenomenon of conflict between the goals, and (iii) the pursuit of low and stable inflation target demonstrates the determination and high responsibility of the Central Bank to the public and that is the basis creating for their prestige.

**SOME CONDITIONS AT THE TIME OF THE IMPLEMENTING OF INFLATION TARGETING FRAMEWORK**

According to experience research of some countries implemented inflation targeting, meeting all the prerequisites of the inflation targeting framework from the beginning is not the necessary
way for these country to be able to successfully implement this framework. Among countries studied, only Canada has in well position in that time it moves into IT framework application. In some countries, only a few prerequisites are met, in other ones, a number of other conditions are ignored or can be gradually established over time within the framework of the process of inflation targeting implementation (see Table 3.2 and Table 3.3)
Table 3.2 Main conditions for adopting inflation targeting successfully

<table>
<thead>
<tr>
<th>Some conditions</th>
<th>Countries meet the conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maintaining price stability is the primary target of monetary policy</td>
<td>Romania and Turkey</td>
</tr>
<tr>
<td>Maintaining price stability is the primary target of besides maintaining other goals</td>
<td>Canada, Chile, Czech Republic, Hungary, Israel and Poland(with exchange rate bands)</td>
</tr>
<tr>
<td>Depend on goal of agree with the government on the strategy changing to inflation targeting</td>
<td>Israel (the government set the goal); Canada, Czech Republic, Hungary and Turkey (both the Central Bank and government set the goal); Chile and Poland (the Central Bank set the goal)</td>
</tr>
<tr>
<td>There is no fiscal dominance (the government approaches limited or be prohibited) with credit source of the Central Bank</td>
<td>Canada, Chile, Czech Republic, Hungary, Israel and Poland, Romania and Turkey</td>
</tr>
<tr>
<td>The Central Bank is independent of using instruments</td>
<td>Canada, Chile, Czech Republic, Hungary, Israel and Poland, Romania, Turkey</td>
</tr>
<tr>
<td>Understand clearly the transmission mechanism of monetary policies</td>
<td>Canada (is appreciated relatively although there are gaps); Chile, Czech Republic, Hungary, Israel, Poland, Romania and Turkey (are trying to implement on the initial basic foundation)</td>
</tr>
<tr>
<td>Control short-term interest rate properly *</td>
<td>Canada, Chile, Czech Republic, Hungary, Turkey, Israel and Poland (although it is reasonable, the control is slightly complex because pursuing the goal of interest rate)</td>
</tr>
<tr>
<td>Develop the financial market in a suitable way</td>
<td>Canada and Chile (well develop), the Czech Republic, Hungary, Israel (relatively well develop), Turkey, Poland,</td>
</tr>
</tbody>
</table>
and Romania (do not develop as well as other countries)

<table>
<thead>
<tr>
<th>Financial markets stabilize reasonably *</th>
<th>Canada, Chile, Czech Republic, Hungary, Israel, Poland, Romania, Turkey</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capacity of modeling / forecasting</td>
<td>Canada (well developed), the rest is in the initial stages, has developed and improved over time</td>
</tr>
<tr>
<td>Mechanisms of accountability</td>
<td>Canada (does not have the mechanisms of accountability official from the beginning, however, they need to explain monetary policy to the public; formal mechanism is established over time), Turkey (via the notification of requirement to the public about the activities of the Central Bank and monetary policy and when the target is not met within the scheduled time).</td>
</tr>
</tbody>
</table>

*Source: Charles Freedman and Otker inci-Robe (2009).*

*Note: *Most countries meet this condition*
Table 3.3 The condition of prerequisites when IT is adopted

<table>
<thead>
<tr>
<th>Country</th>
<th>The prerequisites have been set when IT is adopted</th>
<th>The prerequisites is overlooked when IT is adopted</th>
</tr>
</thead>
</table>
| **Conditions** | - Price stability is the primary and common goal  
- The Central Bank is independent of using instruments at the application time of IT  
- There is no fiscal dominance  
- Controlling short-term interest rates reasonably is established  
- Financial market develops well | - Capacity of modeling / forecasting is not appreciated  
- The understanding of the transmission mechanism and the mechanism working well is ignored  
- There is no double anchors (Poland, Israel, Hungary)  
- Independent of target / legal is overlooked |

| Canada | - Low inflation is one of the goals of monetary policy  
- The instrument of monetary policy is de facto independent  
- There is no fiscal dominance  
- This country controls short-term interest rates effectively  
- Understanding the transmission mechanism. The financial markets are well-developed. The financial system is healthy and stable. | - There is unofficial independence of the goal (the agreement is IT framework needs to be promoted if the goal is the responsibility of both the Central Bank and Government)  
- There is no mechanism for formal accountability although the Central Banks are expected to explain to the public about their responsibilities within IT |

| Chile | - Full independence is established (goals and instrument)  
- There is no fiscal dominance  
- Financial system is stable | - The presence of double anchors is overlooked (the mechanism of exchange–rate regime is maintained to 1999)  
- Understanding of the transmission mechanism is ignored |

60
<table>
<thead>
<tr>
<th>Country</th>
<th>Issues and Achievements</th>
</tr>
</thead>
</table>
| Czech Republic   | - There is no fiscal dominance
- An independent monetary policy is established
- The implementation of monetary policy with key interest rate is effective
- Financial market develops well

| Hungary          | - Price stability is the primary and common goal
- The Central Bank is independent of using instruments at the application time of IT
- Financial system is stable
- Controlling short-term interest rates reasonably is established
- Financial market develops well

| Israel           | - There is no fiscal dominance
- Controlling short-term interest rates reasonably is established
- The de-facto independence of central bank is increasingly increase
- Financial system is stable

- Mandate of price stability is overlooked
- Banking system is weak
- Capacity of modeling / forecasting is not appreciated
- Understanding of the transmission mechanism is ignored
- Trust and accountability is low
- The organizational structure is not suitable
- the support of political is low

- Double anchors are overlooked (exchange rate band extends at the application time of IT)
- Capacity of modeling / forecasting is gradually establish
- There is no knowledge of the transmission mechanism and using more econometrics
- The financial rule has not been established

- The independence of the weak legal
- Basic understanding of the transmission mechanism
- The ability to predict / model gradually improving
- The presence of dual anchor (crawling band, extended step by step)
- Financial market develops well
- Commitment of price stability is set
- There is no fiscal dominance
- Controlling short-term interest rates reasonably is set
- An independent monetary policy is established
- Financial market develops well
The financial system is healthy and stable.

- Double of anchors appear (crawling band extends gradually after applying IT and even floats)
- The financial market is underdeveloped
- Capacity of modeling / forecasting is not appreciated
- The operation of the transmission mechanism is not good
- Data assessing inflation developments is limited
- Capacity of modeling/ forecasting is growing
- Understanding the transmission mechanism is gradually improving.

Source: Charles Freedman and Otker inci-Robe (2009).

Table 3.2 and Table 3.3 show that most countries had a some key elements of the inflation targeting framework at the beginning of inflation targeting implementation, including: (i) stabilizing the price is an aim covering monetary policy (even if there are other goals in the ordinance of the Central Bank), (ii) the Central Bank is independent on using of monetary policy instruments, (iii) the approach of the government for sources of financing of the Central Bank has been banned or restricted, (iii) short-term interest rate is controlled properly, and (iv) the financial system and financial markets stabilize and grow well creating favorable conditions for the transmission of the monetary impact to market interest rates. These factors can be seen as some advantages for many countries successfully adopt the inflation targeting framework. In contrast, in the table above, it also points out that the ability to model and forecast inflation is limited in most countries; economic database is not complete, understanding and activities of the transmission mechanisms is not possible, the central bank is not independent on the law (goal).
Some countries continue to pursue two nominal anchors (exchange rate and inflation target) and they just abandon this mechanism gradually over time. In Poland, crawling band exchange – rate regime are eliminated relatively quickly. However, in Israel and Hungary, the elimination of exchange rate band took 5 years and 7 years respectively, after IT application.

TRANSITION STAGE TO FULL-FLEDGED INFLATION TARGETING FRAMEWORK

To adopt inflation targeting monetary policy efficiently right from the beginning and limit adverse movements, the Central Bank need to meet a number of conditions. Most countries apply full - fledged inflation targeting (FFIT) at the time they control inflation successfully and the consumer price index is decreasing. Therefore, the implementation of policies has created the public confidence in the ability of achieving low and stable inflation of the Central Bank.

The choice between a gradual transition from the old currency regime to IT regime (Chile and Israel)\(^{10}\) and fast transition (Brazil, Czech Republic, Poland, South Africa )\(^{11}\) to IT framework reflects the inflation level at the beginning of the transition (see Table 3.4)

The table 3.4 shows that Chile and Israel are two first countries (after New Zealand) which decide to change to IT framework. Therefore, these countries have more disadvantages because they have to learn and practice at the same time in order to reduce high inflation rate. Other emerging market countries have shorter transitions or change directly to inflation targeting framework. Moreover, the country changed to inflation targeting framework in the late 1990s can get benefit from learning experience of some countries that have adopted IT before.

\(^{10}\)Chile declares that they changed to IT since 9/2990 but till 9/1999, this country adopted IT completely; although Israel state that their IT transition began since 12/1991, in 12/1997 this country apply IT completely.

\(^{11}\)Brazil declares that they adopted IT officially in 6/1999 and apply IT completely; relatively, Czech Republic states that they adopted IT officially in 12/1997 and apply IT completely; Poland
Table 3.4. The inflation rate before the transition to inflation targeting framework

(Inflation Rate is measured by CPI average / year;%)

<table>
<thead>
<tr>
<th>Country</th>
<th>t</th>
<th>Inflation at time t&lt;4 years</th>
<th>Inflation at time t&lt;3 years</th>
<th>Inflation at time t&lt;2 years</th>
<th>Inflation at time t&lt;1 years</th>
<th>Inflation at time t</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>1999</td>
<td>66,0</td>
<td>15,8</td>
<td>6,9</td>
<td>3,2</td>
<td>4,9</td>
</tr>
<tr>
<td>Chile</td>
<td>1990</td>
<td>20,6</td>
<td>19,9</td>
<td>14,7</td>
<td>17,0</td>
<td>26,0</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>1997</td>
<td>…</td>
<td>10,1</td>
<td>9,1</td>
<td>8,8</td>
<td>8,4</td>
</tr>
<tr>
<td>Israel</td>
<td>1991</td>
<td>19,8</td>
<td>16,3</td>
<td>20,2</td>
<td>17,2</td>
<td>19,0</td>
</tr>
<tr>
<td>Poland</td>
<td>1998</td>
<td>33,3</td>
<td>26,8</td>
<td>20,2</td>
<td>15,9</td>
<td>11,7</td>
</tr>
<tr>
<td>South Africa</td>
<td>1999</td>
<td>8,6</td>
<td>7,4</td>
<td>8,6</td>
<td>6,9</td>
<td>5,2</td>
</tr>
</tbody>
</table>

Source: IMF, International Financial Statistics

In general, there is no firmly conclusion about the benefits of gradual approach in comparison with fast approach. The transition period being shorter or longer all based on the initial conditions (the conditions necessary for FFIT has been established from the beginning and it is necessary to have an urgent substitute anchor). Besides, it is based on the speed of achieving the results in flexible exchange rates application and institutional environment / activity environment which help IT adoption goes smoothly.

Gradual approach is motivated by a number of factors. In Turkey, the authorities have a cautious approach. They try to avoid applying IT framework when the conditions are not ripe because it can cause to lose confidence when some basic elements to implement IT successfully can be ignored. Mentioning to the necessity to have an nominal anchor replacing crawling peg regime after the crisis, the authorities apply a part of IT framework until most basic elements of the framework has been established. Similarly, in other countries (Chile, Hungary and Israel), the relatively long transition period reflects a part of many difficulties in setting up a series of institutional requirements concurrently in order to implement IT successfully. This policy means that these countries only cancel gradually the role of nominal anchor of the exchange rate, apply
implicit or partial IT framework whereas they simultaneously participate in inflation target and exchange target. Full-fledged inflation targeting (FFIT) succeeds when the exchange rate band regime is canceled finally.

Some countries have IT approach quicker. For example, in the Czech Republic, the authorities quickly adopted officially IT regime after Koruna forced to leave the horizontal band exchange rate regime in the monetary crisis in mid-1997. The government decided to move quickly to an alternative framework to maintain confidence and stability in market conditions. Inflation targeting has been adopted after six months of urgently preparation when most basic factors in IT implementation were established, although a number of other ones are ignored. Whereas a number of conditions were not established completely, rapid IT adoption required great efforts to enhance capacity and which was a process of "learning by doing". A proper mandate to pursue price stability has been ignored from the beginning, and it only was adopted officially after a few years. In addition, an understanding of the Central Bank of the monetary transmission mechanism, as well as the ability to model and predict more effectively only were the next few years after IT adoption.

The experience of the Czech Republic raised some debates about the independence of the Central Bank whereas the awareness and public support for the new regime was limited, and the lack of an explicit statement for price stability. Despite these difficulties, IT mechanism adoption is relatively quickly which help overcome economic crisis faster, and the confidence in IT mechanisms is still stable since then. Even in where IT framework is adopted not in crisis conditions, the lack of prerequisites is the challenge. Specifically, in Poland, an understanding monetary policy mechanism transmission of and limited forecasting capacity has made monetary management problems more complex in the early years of IT adoption.

Overall, some efforts to improve capacity of flexible exchange rate mechanism promote the country's ability to apply IT as a framework for a new monetary policy. In both Poland and Czech Republic which are two countries change to IT after a short time, the authorities have established some factors of flexible exchange rate regimes at the time they allow their currencies floating. These factors include: developing efficiently foreign exchange market, establishing the
management system of foreign exchange risk relevantly, setting up consistent intervention policy and establishing the capacity of monetary policy implementation appropriately which includes the ability affecting short-term interest rates. In these countries as well as countries with longer transition period (Chile, Hungary, Israel and Turkey), these elements are setting up gradually over time, promote the operation of full-fledged inflation targeting framework with a floating exchange rate regime. Therefore, establishing the ability to IT implementation and changing to a flexible exchange rate regime need to be strengthening at the same time.

MACROECONOMIC RESULT OF DIFFERENT MONETARY POLICY MECHANISMS

This section will review the evidence of the inflation targeting implementation. First, it determines whether the Central Bank pursues inflation targeting meeting the objectives of inflation successfully as it has declared. Second, this section makes some assessments based on broader basis for the implementation of the macroeconomic targets within inflation targeting framework in comparison with the alternative policy framework.

According to the research of Roger (2009)\textsuperscript{12} and Filho (2010)\textsuperscript{13}, the comparison of the macroeconomic results shows that some low-income countries adopting inflation targeting monetary policy framework implement more appreciated than low-income countries with other monetary policies.

The comparison of inflation and growth results is done in some high-income and low-income countries applying IT and some low-income countries not applying it in 1990 and 2000. Some of the results are drawn as follows:

\textsuperscript{12}Scott Roger, Inflation Targeting at 20: Achievements and Challenges, IMF Working Paper, October 2009

First, all low-income countries implementing IT or not witness a significant reduction of the inflation rate along with the improvement in the growth rate. However, some countries implementing IT have the greater improvements in both inflation and growth. Reducing the inflation rate in those low-income countries implementing IT is about 5.8 percent in comparison with the decrease in the other ones which do not adopt IT, while the growth improvement point is 0.7 percent. The high-income countries, which most of them has adopted IT earlier in the 1990s, maintain the low inflation rate and moderate improvements in growth rate; whereas, high-income countries which do not adopt IT often reduce growth rate\textsuperscript{14}.

Second, low-income groups (even if they implement inflation targeting monetary policy or not) all achieve significant reduction of inflation and production fluctuations. However, many countries implementing IT have a greater result the reduction of inflation and production volatility.

Particularly, the low-income IT countries reduce 4.9 percent in the standard deviation of inflation in comparison with the low-income countries which do not implement IT, and decrease 0.7 percent in growth volatility\textsuperscript{15}. The high-income countries also have greater reduction in inflation and growth volatility.

Some formal statistical analysis (based on quantitative methods) are about the benefits of the inflation targeting implementation as well as similar conclusions as some statistical analysis described above (see Ball and Sheridan, 2003, Mishkin and Schmidt - Hebbel, 2005, IMF, 2005, Vega and Winkelried, 2005).

According to the analysis of IMF (2005), during the period of research with some countries in the sampling, IT countries respectively reduce 4.8 percent in the inflation average in comparison with countries which apply other monetary policies. Interestingly, this number is very close to the figures obtained from the study of Mishkin and Schmidt - Hebbel (2005) and Vega and

\textsuperscript{14} Scott Roger, Inflation Targeting at 20: Achievements and Challenges, IMF, Oct.2009, Ward

\textsuperscript{15} Scott Roger, Inflation Targeting at 20: Achievements and Challenges, IMF, Oct.2009, Ward
Winkelried. Inflation target also corresponds to 3.6 percent reduction in inflation volatility (measured by the standard deviation of inflation) compared with some countries which adopt other strategies. Under inflation targeting mechanism, long-term inflation expectation is lower and more stable than other mechanisms. It is important that there is no evidence that whether IT countries achieving the inflation target have to exchange to stability in real production.

All analysis using both descriptive statistical methods and quantitative methods showed that, in general, the countries implementing the administration framework of inflation targeting monetary policy have better macroeconomic results than the countries using the other frameworks.

**CAPABILITY OF COPING WITH ECONOMIC SHOCKS**

Whether IT countries able to cope with economic shocks better such as international commodity price shocks or global financial shocks in comparison with other countries which do not adopt IT is a raised question after considering IT framework. There are a number of researches attempt to answer this question after many countries have suffered from high commodity price shocks and global financial crisis shock. However, because these economic shocks have occurred recently, assessments are also limited in terms of data. The section below attempts to summarize some results from the case study in order to consider the possibility of reaction of shocks of some countries which implement inflation targeting monetary policy and the other ones do not.

Analysis which uses quantitative data tools before international commodity price shocks and global financial shocks in 2007-2008 supports the view of inflation targeting corresponding to lower volatility of financial markets in comparison with other monetary policy mechanisms. Some results from the quantitative analysis show that: Firstly, some countries adopting inflation targeting monetary policy implement better than other countries in reduction high commodity prices on inflation in 2007. Second, macroeconomic forecasts also pointed out that the IT countries are expected to be less affected negatively by the global financial crisis. Up to 5/2009, the index forecasts demonstrate that the median growth in groups of all countries in 2009-2010
will fall below the median growth in 2001-2008. Furthermore, along with lower commodity prices, inflation is expected to fall below the rate of inflation average. However, median growth in the countries which adopt IT is expected to decline 4.8 percent in 2009-2010 compared to the 2001-2008 period, and down 3.7 percent in comparison with low-income IT countries, and down 3.4 percent in comparison with high-income countries. Inflation in some groups of countries is expected to reduce with similar quality compared with the average value in 2001-2008 periods.

Some economists emphasize the benefits of IT in terms of increase the credibility of policy, communications capability to form better inflation expectations and IT is characterized by anchoring flexible exchange rate. This feature makes it more responsive to external economic shocks than other monetary policies. On the other hand, there are a number of other reasons why IT provides the suitable tools for dealing with the financial crisis in 2008. First, the risk of deflation is more focused after the financial crisis of 2008. When faced with the risk of deflation, IT mechanisms may play an important role in order to avoid the liquidity trap and the risk of interest rate being close to 0. This is emphasized in the communication strategy of the Central Bank towards inflation targeting.

Second, the reliability of the IT framework also allows the Central Bank to adopt IT in developing countries which have greater substantial opportunity for easing monetary policy without damaging their inflation concerns.

Third, during the global boom and excessive liquidity situation, the Central Bank implements IT toward tight monetary policy in order to pursue their inflation target. The countries implementing IT have higher interest rate during the expansion period before crisis. And when the crisis impacts, the countries with higher nominal interest rates have more chances to reducing interest rates; thus they have less need for extremely costly fiscal measures.

Fourth, there is a significant correlation between inflation targeting and flexible exchange rate mechanism. In a long time, flexible exchange rate is regarded as having the ability to absorb economic shocks and this also explains that the deal with the crisis is appropriate relatively of IT countries.
In quantitative study of Filho (2010), in order to compare the countries adopt IT and the others do not when dealing with the global financial crisis in 2008, it has concluded that the monetary policy of the IT countries became more appropriate when these countries coped with the crisis. The IT countries in general seem to avoid deflation risks better the others. The flexible exchange rate mechanism, the IT countries also witness strong price reduction which does not result in the greater risk of the market. Accordingly, there is evidence showing that the IT countries do better in terms of the unemployment rate and developed IT countries have relatively appropriate industry production. With GDP growth rate, the developed IT countries have GDP growth higher than the others do not adopt but there is no difference among emerging countries.

CONCLUSIONS ON LESSONS LEARNED OF THE COUNTRIES

In order to implement successfully an official inflation targeting framework, it is necessary to have certain conditions. However, the absence of several conditions does not prevent the countries make the transition towards inflation targeting framework. However, the experience of many countries shows that lacking some of the basic elements will make the successful implementation of the inflation targeting framework become more difficult and challenging. Thus, the countries should avoid announcing inflation targeting before reaching some minimum conditions within inflation targeting framework. The experience in some countries points out that the following factors is important to help IT framework become more feasible and less challenging: (i) stability price is the overarching objective of monetary policy; (ii) there is no financial institutions pressure; (iii) the Central Bank is independent in the using of their instruments; (iv) high consensus in the country about the importance of the inflation target is necessary; (v) the fundamental understanding about the transmission mechanism of monetary policy and the appropriate ability influencing on short-term interest rates are important, and (vi) the financial systems and markets operate properly. These factors can be considered as the basic conditions ensuring that IT framework operates successfully.

There is no unique effective way leading to adopt IT. It is a mistake to assume that in order to adopt IT successfully, it is necessary to establish all the conditions before the IT framework is put in place. The experience in some countries shows that in many countries which is
implementing IT successfully now, a number of conditions are not implemented from the beginning. However, the authorities have established these conditions over time, and also applied "learning by doing" method. The Central Bank will try its best to establish the necessary conditions and work with Government towards the target.

Evidence also shows that the adoption of IT promotes the development of the factors contributing to the successful implementation of IT. Therefore, the establishment of supporting elements for a successful IT framework also needs to be strengthened at the same time. The establishment of some key factors that can promote the application of some form of IT (e.g.: implicit IT, partial IT). Besides, for its part, this will promote to set up the premise for a successful FFIT framework. Some important factors in the transition to FFIT are: (i) maintaining macroeconomic policies and healthy structural policies to create a suitable environment for IT, (ii) focusing the work on establishing the premises, and (iii) promoting efforts to meet the requirements of a more flexible exchange rate regime. These factors will help countries to avoid sudden shocks from the exchange rate mechanism.

The experience in some countries also points out that the Central Bank implementing IT should be careful to avoid losing confidence and sapping the future effectiveness of monetary policy. Any target amendment or target parameters should be announce clearly to the public, and it is necessary to point out that monetary policy continues to over concentrate on controlling inflation in the medium term. In order to cope with the lack of the commitment of a low inflation rate, the Central Bank needs to adopt a decisive plan to bring inflation return to set objectives.

Some events in mid-2007 and mid-2008 also show a series of challenges that policy makers have to face in the context of increasing globalization. Being responsible for inflation target tasks, the Central Banks which adopt IT have to deal with volatility in the commodity markets, the global financial turmoil, the economic recessions, the reversals of the capital flows and the decreases in exchange rate. The Central Bank should balance these risks in order to be against the risks of new inflationary pressures after the reversal in commodity prices because many policy makers in advanced and emerging economies ease monetary policy to deal with the economic outlook worsening. Therefore, the current environment is more difficult and volatile considerably. It is
also important that the Central Bank needs to look ahead in the reaction to its policy while the
Central Bank is mindful of the possibilities and serious charge which may be happen.
CHAPTER 4
REALITY OF OPERATING MONETARY POLICY IN VIETNAM

THE ECONOMIC DEVELOPMENT SITUATION OF VIETNAM

According to several experts, Vietnam should consider two factors about demographic when building the overall economic policy. The first factor is that the majority of Vietnam’s population is under 20 years old while the second factor is the process of urbanization which leads more and more people in rural to migrate to urban. In order to satisfy sufficient employment for the people reaching to working age, Vietnam must have high growth. Vietnamese government has done this in recent years in which average economic growth in the period of 2006-2010 is 7.0%/ year\(^16\). However, an issue is that if maintaining potential growth is not oriented in a reasonable way which leads economy to be able grow without generating inflation, we cannot know the real extent of output gap is, and also cannot know the ability of economic development so as to not generate pressure on human resources and physical capacity, because this causes inflation. Unfortunately, this has led to a period of serious inflation in the economy since 2004, and reached a peak in 2008 when the inflation rate reached 19.9\%. In a report of International Monetary Fund (IMF) entitled “Vietnam: The selected issues”\(^17\), there is a section titled “What drives inflation in Vietnam? A regional approach”. The main conclusions of this section are as follows:

- Inflation rate in Vietnam has increased rapidly since 2003, and was approximately 8\% in October 2006. This is higher than that of regional countries.

\(^{16}\) According to the Government’s report on the economic-society situation in 2010 and planned socio-economic development in 2011, the growth rate of GDP per year in the period of 2006-2010 is estimated at 7.0\% (target is expected to be 7.5\%-8.0\%)

\(^{17}\) IMF, “Vietnam: The selected issued”, November 2006
The long inflation situation has been more impact on the Vietnam’s economy than that of other countries in the region. This means that the reduction of inflation expectation in Vietnam can be more difficult than that of other countries.

The report also indicated that the economy probably operating approached to near to or even above potential since 2005, leading output gap to be no longer available. This causes pressure on prices for the entire economy. Moreover, the report claimed that since 2002, it seems to have a positive relationship between the scale of money supply and inflation, with a lag of about 12 months. During that period, the credit growth rate in the economy seems to be more related to the rate of consumer price index, demonstrating that the credit can be the leading indicators to measure inflation.

When considering the happening from 2006 until the second half of 2010, we can see that the prediction of IMF was correct and inflationary pressures in fact were even stronger. The impact of this pressure has shifted from demand-pull to higher price. Inflation expectation became more powerful. Moreover, when inflation pressures were high, the stock market bubble and real estate became tenser. Then reverse movements on stock markets were very serious when market prices fell by more than two-thirds in 2009, and continued to decline in 2010. With regard to real estate market, an important happening is occurring, when real estate price have increased a lot compared to level that most people in Vietnam can afford. An important question is why inflation in Vietnam is much higher than that of other countries in the region and main competitors in the region (see Table 4.1)
Table 4.1. Inflation rate in emerging countries (%/ year)

<table>
<thead>
<tr>
<th>Country</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011e</th>
<th>2012f</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>1.5</td>
<td>4.8</td>
<td>5.9</td>
<td>-0.7</td>
<td>3.3</td>
<td>4.6</td>
<td>4.2</td>
</tr>
<tr>
<td>Indonesia</td>
<td>13.1</td>
<td>6.4</td>
<td>9.8</td>
<td>4.8</td>
<td>5.1</td>
<td>6.3</td>
<td>5.8</td>
</tr>
<tr>
<td>Malaysia</td>
<td>3.6</td>
<td>2.0</td>
<td>5.4</td>
<td>0.6</td>
<td>1.7</td>
<td>3.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Philippines</td>
<td>6.2</td>
<td>2.8</td>
<td>9.3</td>
<td>3.2</td>
<td>3.8</td>
<td>4.9</td>
<td>4.5</td>
</tr>
<tr>
<td>Singapore</td>
<td>1.0</td>
<td>2.1</td>
<td>6.6</td>
<td>0.6</td>
<td>2.8</td>
<td>3.2</td>
<td>2.0</td>
</tr>
<tr>
<td>Thailand</td>
<td>4.7</td>
<td>2.2</td>
<td>5.4</td>
<td>-0.9</td>
<td>3.2</td>
<td>3.5</td>
<td>3.0</td>
</tr>
<tr>
<td>Laos</td>
<td>6.8</td>
<td>4.5</td>
<td>7.6</td>
<td>0.0</td>
<td>6.0</td>
<td>6.5</td>
<td>6.0</td>
</tr>
<tr>
<td>Cambodia</td>
<td>6.1</td>
<td>7.7</td>
<td>25.0</td>
<td>-0.7</td>
<td>4.0</td>
<td>5.5</td>
<td>5.5</td>
</tr>
<tr>
<td>Average CPI in South East Asia</td>
<td>6.8</td>
<td>3.9</td>
<td>8.6</td>
<td>2.5</td>
<td>4.0</td>
<td>5.1</td>
<td>4.2</td>
</tr>
<tr>
<td>Average CPI in Asia Pacific</td>
<td>3.3</td>
<td>4.4</td>
<td>6.9</td>
<td>1.2</td>
<td>4.4</td>
<td>5.3</td>
<td>4.6</td>
</tr>
<tr>
<td>Vietnam</td>
<td>7.5</td>
<td>8.3</td>
<td>23.0</td>
<td>6.9</td>
<td>9.2</td>
<td>13.3</td>
<td>6.8</td>
</tr>
</tbody>
</table>


Note: e is expectation, f is forecast.

Apart from China, we can see that the GDP growth rates in the whole period of other countries were lower than that of Vietnam (see Table 4.2), but inflation rates in such countries were much lower than that of Vietnam. So what is the reason? These countries were also affected by external factors which led their price level to increase as much as that of Vietnam such as changes in gasoline price, commodity and basic food prices. Does this mean that Vietnam’s economy was less productive than that of the region? Are the labor market and Vietnam’s goods be less flexible than that of other countries. There are many regulations that prevent the economy to react to the happening pressure by adjusting the price structure in a quick way. Because of the fact that inflation is finally a monetary phenomenon, so that is it true that monetary policy in Vietnam is too easy and less effective? Or is it because of the coordination of the macroeconomic policies being asynchronous? These are very important issues that need to be
It can be said that, from 2008 to now, Vietnam has been facing difficult economic conditions. Costs have pushed up prices, and prices also have pushed up costs, while inflation expectation has increased more and more strongly. Moreover, the current account balance in Vietnam has continued to be deficient, despite its improvement (-11.8% of GDP in 2008, -6.2% of GDP in 2009, and -4% of GDP in 2010)\(^{18}\), exports and foreign investments have been affected by the global financial crisis and financial market volatility.

In addition, the budget deficit continued to rise while investment efficiency was low. Moreover, the coordination between monetary policy, exchange rate policy, fiscal policy, income policy,

\(^{18}\) Source: ADB, Asian Development Outlook 2011 (April 2011)
and policies related to the promotion of regional economic development was incomplete. Coordination between agencies was not closely monitored. All these factors created the macroeconomic instability and deterioration of market confidence, investors and citizen’s confidence in the policy environment, the macro-management capacity of government.

The following section will examine the origin of the shock impact on the economy, these shocks have shaped macroeconomic context of Vietnam in period of 2000-2010. In the objective framework of the Project, we focus on the two most important macroeconomic variables in the economy such as economic growth and inflation.

The economic growth of Vietnam in the period of 2000-2010 has been primarily influenced by three negative external shocks. Three shocks on economy are Asian financial crisis in period of 1997\textsuperscript{19}, the price of commodity and gasoline on the world market increased in 1997, and the global financial crisis in 2008 which lead the economy to decline, increase unemployment, and subsequently to deflate. The shock from international petroleum prices soaring in early of 2008 has led the economy to decline as well as to push up inflation.

Facing with negative shocks affecting the economy, the government has designed and implemented the response policy in which it should be noted that two key policies are fiscal policy and monetary policy. Initially, both of these policies are to minimize the negative impact of the shocks, though, when it is used excessively, it will react and become economic shocks, known as policy shocks. For example, when a loose monetary policy and expansionary fiscal policy was launched in 2009 to stimulate the economy from the negative impact of the global financial crisis in which when the economy returned to trajectory, the government needs to use strategy to gradually withdraw stimulus. However, loose monetary policy and expansionary fiscal policy which continued to perform when the economy has strongly recovered has increased significantly inflation rate in 2010.

The Asian financial crisis in 1997 had a negative impact on the economy. In 1999, government implemented stimulus policies in which in the following years, economic growth rates were

\textsuperscript{19}The Asian Financial Crisis in 1997 occurred in 1997, prior to the study period 2001-2010, though, the response policy of the Government in 1999 which was to revive the economy after negative shocks created “policy shock” that impacted the economy in the period of 2001-2010
higher than that of last year while the increase of price level was also triggered and reached a peak in 2007, and inflation rate was higher than two digits. This shock policy led the economy to exceed potential growth\textsuperscript{20} and stimulate inflation.

In 2008, the combination between the increase of gasoline prices in the world market, loose monetary policy, and expansionary fiscal policy for a long time ago has led inflation to increase with the figure being up to 23\% in 2008 although gasoline prices in the world market and domestic prices have fallen sharply in the last months of 2008 due to impact of the global financial crisis. Facing with shocks, the government has implemented the tight monetary policy and narrow fiscal policy. Interest rates being very high in 2008 made difficulties for many enterprises. The stock market and real estate market became sluggish and freezes. Economic growth witnessed downward trend while unemployment rate rose.

Not yet to suffer all impact of tight monetary policy and narrow fiscal policy in the end of 2008, the financial crisis and global economic recession affected the domestic economy. The response policy was reversed. Narrow fiscal and monetary policy was moved to expansionary fiscal and monetary policy. The large-scale stimulus package was implemented in 2009. In 2009, economic growth was strongly decreased, with figure being only 5.32\%. However, world economy background tended to recover as well as the witness the effectiveness of stimulus policies in which the economy had a sign of recovery in 2010.

In 2010, the recovery of world economy increased demand for gasoline and raw material for manufacturing operations. The prices of different inputs for production increased in which a loose monetary policy and expansionary fiscal policy stimulated the economy to pull the economy back to potential growth trajectory pushing inflation in 2010 of our country to 11.8\%. Once again, we were witnessing the policies designed to mitigate the negative impact of shocks that create another shocks for the economy. Facing with rising inflation situation and continuous

\textsuperscript{20} The potential growth rate in the period of 2001-2010 was at 7.6\%; we calculated this rate based on following steps: (i) split original number chain from GDP (based on 1994 fixed price, in billion dong) into long-term component and cycle component based on Hodrick-Prescott procedures with adjudging coefficient; (ii) calculate growth rate of an economic from long-term trend chain and take average of growth rate in this period for getting potential growth rate.
rising trend, government has made action message for 2011 which is curbing inflation and macroeconomic stability.

The Figure 4.1 shows that policies of government designed to restore the economy in 1999 which led the economy to exceed the potential growth and pushed inflation. The external shock has made the economy to decline in 2008 and 2009. The movement of policy in 2009 was similar to that of 1999, it means that the stimulus policies were implemented; and the economy quickly was recovered, but led the inflation to rise at the same time.

The Figure 4.2 demonstrates trend of inflation rate and economic growth in period of 2000-2010. A notable situation from this figure is that the inflation rate tended to rise strongly, while economic growth tended to decrease (see Figure 4.2 and Table 4.3).

![Figure 4.1. Economic growth in period of 2001-2010 (%/year)](image)

**Source:** General Statistics Office

**Figure 4.3. Average annual inflation rate and average annual GDP growth rate**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Average inflation rate (CPI) (%/ year)</td>
<td>3,4</td>
<td>5,1</td>
<td>11,4</td>
</tr>
<tr>
<td>Average GDP growth rate (%/ year)</td>
<td>6,96</td>
<td>7,51</td>
<td>7,02</td>
</tr>
</tbody>
</table>
Another trend which should also be mentioned in the period of 2000-2010 is inflation rate being much more volatile than economic growth rate. The standard deviation of the variable inflation rate reached 6.57 while the standard deviation of variable growth rate was around 0.97. The higher standard deviation is, the stronger fluctuation of variable is. Thus, the fluctuation of inflation rate was greater than that of growth rate. It seems that fiscal policy and monetary policy was trying to reduce business cycle volatility and trade-off with higher inflation as well as greater volatility. In the long-term, this policy would reduce economic growth, increased macroeconomic instability and reduced investment.

![Figure 4.2. Inflation and economic growth in period of 2000-2010 (%/year)](image)

In the period of 2000-2010, the economy suffered a major shock that was mentioned above, though, in this period, there were positive impacts on the economy through trade and investment which can be considered as the “positive shock” related to the openness of domestic markets, reducing barriers to trade and investment, thereby promoting competition and economic efficiency. First, The United States-Vietnam Bilateral Trade Agreement was officially signed on

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21 The standard deviation is calculated by the following formula: in which

$X_t$ is the observed value of variable at time $t$, $x$ is the average value of the data series;

$$s = \sqrt{\frac{1}{n-1} \sum_{t=1}^{n} (x_t - \bar{x})}$$

$N$ is the number of observed data series.
13/07/2000 in the United States. Second, the Agreement between Japan and Vietnam for Liberalization, Promotion, and Protection of Investment was signed in Tokyo, Japan on 14/11/2003. This Agreement is not only extended attraction of foreign direct investment channel but also create a foundation for attraction of other indirect investment such as credit for investment projects in Vietnam, making the foreign entrepreneurs to become more interested in Vietnam. Third, Vietnam was officially admitted as the 150th member of the World Trade Organization (WTO) on 07/11/2006. Joining the WTO is expected to bring positive factors for the economy, though, in 2007, although the FDI flowing into the domestic economy reached a record number, trade deficit was becoming very large. Moreover, since Vietnam joined the WTO, commodity prices and gasoline prices on the world market have increased, after that the shock of financial crisis and consecutive global economic downturn has affected negatively the economy, so that it’s difficult to point out the positive effects of joining the World Trade Organization.

As can be seen the Figure 4.3, it is difficult to figure out the effect of “integration shocks” on the trade balance. Both exports and imports tended to increase during the period from 2000 to 2008. However, the financial crisis and global economic downturn had a real impact on the trade balance in which both exports and imports fell sharply in 2009. When the world economy had signs of recovery exports and imports gradually have increased again.

Figure 4.3. Exports, Imports, and Trade Balance (million USD)

Source: General Statistics Office
In summary, in the past 10 years (2000-2010), especially in period of 2006-2010, the growth rate tended to reduce while inflation rate tended to increase. The trend of monetary policy in recent years is generally a prudent expansion to contribute the economic growth and to curb inflation rate. In several time (e.g, in early 2008, in late 2010), in order to limit the proliferation of inflation rate, the State Bank of Vietnam has used synchronous tools to tighten monetary. However, monetary policy was not quite effective, especially the coordination between monetary policy and fiscal policy, so that inflation continued to increase and reached 11.8% in 2010, resulting in a negative impact to economic growth and sustainable development. The following section will analyze deeply about operating mechanism of monetary policy of the State Bank of Vietnam in period of 2000-2010 and the issues raised.

MECHANISM OF MONETARY POLICY MANAGEMENT OF THE STATE BANK OF VIETNAM

The monetary policy of the State Bank of Vietnam includes: (i) setting up project to operate annual monetary policy: on the basis of macroeconomic indicators (inflation, GDP etc...) provided by the National Assembly, the State Bank plans annual monetary policy to achieve the National Assembly’s objectives and submit to the Government for approval, SBV also proposes orientation for monetary policy management and sets oriented monetary targets of the Year; and (ii) setting up coordinating plan for monetary policy, credit, monthly rates, quarterly rates, unscheduled monetary policies: the State bank closely monitors the domestic and international economic and monetary changes, makes analysis, reviews and assesses the operating solution for monetary policy tools implemented; forecasting currency movements; building projects operating monetary policy strictly under direction of the Government, to coordinate with the other macroeconomic policies; proposing solutions to operate monetary policy to stabilize the money market, contributing to inflation control and macroeconomic stability.
OBJECTIVES OF MONETARY POLICY IN VIETNAM

The ultimate objective of monetary policy

Law on the State Bank of Vietnam 1997 (Article 2) provides:

"The national monetary policy is a part of the State's economic financial policy aimed to stabilize currency value, control inflation, partially boost the country's socio-economic development, assure national defense, security, and improve people's living standards”.

Clause 1, Article 4 of the Law on the State Bank in 2010 provides that: "The State Bank conducts operations for the purpose of currency value stability; assures the safety for banking operations and the system of credit institutions; assures the safety and effectiveness of the national payment system; and contributes to accelerate socio-economic development along the socialist orientation”.

It can be seen that this monetary policy was too widely-targeted and lack of specification. Therefore, it not only put pressure but also complexity on implementation of State Bank’s policies. Besides, it was not exact enough to evaluate the effectiveness of monetary policy implementation in each period. The implementation of monetary policy, which has had dual ultimate target, was complex, while the monetary policy of the Vietnam had to pursue a lot of such target but has not decided which the ultimate one was. That was indeed a big difficulty for the State Bank of Vietnam.

Since the implementation of the Law on the State Bank, on the basis, we can see that the monetary policy has always pursued objective of stabilizing currency value, curbing inflation and contributing to the economic development. However, the Law on State Bank did not specify the top target of monetary policy. Thus, in fact, the monetary policy management has some difficulties, especially when there is a tradeoff between the inflation control target and economic growth. Beside the objectives defined in the Law on State Bank, in each specific period, the State Bank also pursued objectives such as ensuring banking system safety. So, the fact that State Bank often pursues many monetary policy targets, has not clearly defined top objectives, and has
not fully quantified some objectives, that lead to shortcomings, making difficulties in conducting monetary policy.

In practice, every year, the State Bank’s monetary policy management aimed at controlling inflation and supporting economic growth towards targets. But the pursuit of the targets in some years, have had some difficulties, especially from 2004 to now. For example, in 2004 and 2005, the inflation target was set under 5 % and 6.5 %, but the CPI result controlled was at 9.5 % and 8.4%. In 2010, the inflation target was 7-8 %, but actual inflation was at 11.8 %. For the aim of economic growth, annual actual GDP generally engaged with the target, but there has had certain differences (see Table 4.4).

**Intermediate objective of monetary policy**

*Total liquidity (M2)*

Since 1992, the State Bank has paid attention to amount of money in the economy in a broad sense (M20), not only amount of cash as before 1990. At the same time, the monetary statistics has also complied with the criteria of the International Monetary Fund.\(^{22}\)

In terms of theory and practice of developed countries, to control increase level of M2, the Central Banks are required to determine the increase Monetary Base (or operation target is volume ) , or control interbank interest (or operation target is price). In fact, since 1995, every year, to achieve the monetary policy objective, the State Bank has determined the oriented target for M2, credit for economy. In the period of 2000-2005, there had a difference between the target for M2 in orientation and in practice, but in a not so high level, only about 0.5 to 5 %. However since 2006, the difference between the target for M2 in orientation and in practice has increased. This was because of Vietnam’s integration into the world economy while the national economic

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\(^{22}\)The volume of currency in the economy in the broad sense (M2, or total liquidity), includes: total amount of cash outside the banking system + deposits in VND and foreign currencies of residents and businesses at commercial banks; the State Bank’s Monetary Base (MB), is defined to include: cash outside the State Bank + deposits of credit institutions in the State Bank. The volume of money in the economy (M2) and the Monetary Base (MB) defined above is completely suitable to the view of Central Bank of the countries in the world.
situation and world economic situation experienced complex fluctuations, which had many impacts on the oriented monetary targets. For example, in 2007, oriented target for M2 was 20-23 %, while in fact, M2 grew at 46.12 %; in 2008, M2 oriented target was 32 %, while the actual M2 growth was 20.31 %. Similarly, M2 target in orientation was quite different from actual M2, in 2009 and 2010 (see Table 4.4 and Chart 4.4).

The main cause of the fact that actual M2 growth, in some years, was not close to the orientation is:

The State Bank did not clearly set intermediate targets, so in fact, the management of monetary policy tools sometimes directed to credit control, interest rates and exchange rates. With the operation of monetary policy directed at so many intermediate targets, monetary policy management was usually passive, the effectiveness of monetary policy was not high, and market regulation did not meet the expected targets.

<table>
<thead>
<tr>
<th>Year</th>
<th>Criteria</th>
<th>Growth</th>
<th>Inflation</th>
<th>M2</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>Target</td>
<td>5.5 - 6</td>
<td>6</td>
<td>38</td>
<td>28 - 30</td>
</tr>
<tr>
<td>2000</td>
<td>Performed</td>
<td>6.8</td>
<td>-0.6</td>
<td>38.96</td>
<td>38.14</td>
</tr>
<tr>
<td>2001</td>
<td>Target</td>
<td>7.5 - 8</td>
<td>&lt; 5</td>
<td>23</td>
<td>20-25</td>
</tr>
<tr>
<td>2001</td>
<td>Performed</td>
<td>6.89</td>
<td>0.8</td>
<td>25.53</td>
<td>21.44</td>
</tr>
<tr>
<td>2002</td>
<td>Target</td>
<td>7 -7.3</td>
<td>3 - 4</td>
<td>22 - 23</td>
<td>20 - 21</td>
</tr>
<tr>
<td>2002</td>
<td>Performed</td>
<td>7.08</td>
<td>4.0</td>
<td>17.7</td>
<td>22.2</td>
</tr>
<tr>
<td>2003</td>
<td>Target</td>
<td>7 – 7.5</td>
<td>&lt; 5</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>2003</td>
<td>Performed</td>
<td>7.34</td>
<td>3</td>
<td>24.94</td>
<td>28.41</td>
</tr>
<tr>
<td>2004</td>
<td>Target</td>
<td>7.5 - 8</td>
<td>&lt; 5</td>
<td>22</td>
<td>25</td>
</tr>
<tr>
<td>2004</td>
<td>Performed</td>
<td>7.79</td>
<td>9.5</td>
<td>30.39</td>
<td>41.65</td>
</tr>
</tbody>
</table>
State Bank has not really controlled all the factors affected M2, especially the factors that can alter net foreign assets and net government lending. In particular, that is the following factors: (i) the change in net foreign assets: the State Bank’s M2 control was in difficulty and passive by outflow of foreign currency, (ii) the changes in credit investment for the economy is the main factor affected to changes of the M2, thereby affecting economic growth, and inflation; (iii) changes in items of government net lending (reflecting the changes in revenue and expenditure of government sector): for countries with stable fiscal policy, there’s no big change in this issue. However, in reality for many years, our country experienced great change in this item. Therefore, in order to control M2, we cannot ignore the changes of this item. At the same time, for the government net lending, according to the regulation of Monetary Statistics by IMF, are accounted for on the balance sheet of the whole banking sector with a negative sign, which means more government deposits are, the lower M2 is. But in fact, government deposits at the

<table>
<thead>
<tr>
<th>Year</th>
<th>Target</th>
<th>Performed</th>
<th>Δ Growth</th>
<th>Δ Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>8.5</td>
<td>8.44</td>
<td>&lt; 65</td>
<td>22</td>
</tr>
<tr>
<td>2006</td>
<td>8</td>
<td>8.23</td>
<td>6.6</td>
<td>33.59</td>
</tr>
<tr>
<td>2007</td>
<td>8.2 - 8.5</td>
<td>&lt; 8</td>
<td>20 - 23</td>
<td>17 - 21</td>
</tr>
<tr>
<td>2008</td>
<td>8.5 - 9</td>
<td>6.31</td>
<td>19.9</td>
<td>20.31</td>
</tr>
<tr>
<td>2009</td>
<td>5</td>
<td>5.32</td>
<td>6.50</td>
<td>28.99</td>
</tr>
<tr>
<td>2010</td>
<td>6.5</td>
<td>6.78</td>
<td>11.8</td>
<td>33.3</td>
</tr>
</tbody>
</table>

Source: The State Bank, General Statistic Office
commercial banks involved in the money creation process, thereby affecting the supply and demand of capital and the market interest rate that the State Bank can not control; and (iv) changes in other items also affects to the change of M2.

**Graph 4.4. M2 growth in practice and in target (%/ year)**

Thus, to control the increase in M2 to orientation, which requires State Bank to control the factors can have impact on M2. In addition, the State Bank also has to control the amount of deposits of the other banking activities. However, since 2000 until now, other organizations having banking activities have developed with relatively big scale, such as the Development Assistance Fund (Vietnam Development Bank, the insurance system, the State Treasury, etc...), are out of control of the State Bank. The above analysis has explained the reason why the effect of M2 to the variables of the economy was not clear, the movement of the total means of payment as M2 with the meaning of intermediate objectives was inconsistent with economic growth and inflation (see Chart 4.5).

**Chart 4.5: M2 movements, economic growth and inflation (% per year)**
Credit investment control for the economy

In the objective of annual monetary policy, credit growth is considered an important criteria to support economic development. Since 1991 to present, not only the State Bank but also the government and the ministries have been very interested in the growth rate of credit to the economy. In terms of underdeveloped stock market, credit of the banking system is the important capital supply channel, mainly for development and innovation of economic structure, equipment and technology of the businesses.

The control of credit to the economy was performed by State Bank on two aspects: (i) the State Bank have continuously improved credit policies towards more ventilation, autonomy enhancement, self-responsibility of credit institutions, while ensuring principles of safety and effectiveness. So far, after some revisions and supplementations, credit mechanism was basically complete, the problems in reality have gradually been repaired, (ii) control the level of credit growth. It is said that the State Bank’s credit control towards orientation has many limitations. Over the years, credit growth has actually not been close to the orientation (see Table 4.4). Although the State Bank has annually set oriented targets, in fact, the State Bank used monetary policy tools, such as interest rates, refinancing, etc... to influence, regulate and control credit growth towards orientation, which had many difficulties. For example, in 2007, oriented credit growth was 18-22%, while actual credit growth was 53.89%, similarly, in 2010 orientated credit growth was 25% while credit growth in fact was 32.4%, much higher than orientation, and, State Bank had been very difficult to regulate to reduce the actual credit growth.

\[^{23}\text{In the scope of this paper, we mainly focus on analysis of controlling the level of credit growth of the State Bank, because the control of credit growth level is closely involved in the State Bank’s M2 control.}\]
Operating objectives

In the condition that currency market in Vietnam was not really developed, competition among banks was not high, the reactions of credit institutions (CIs) to the change of market had many limitations, which lead to the interest rate of the State Bank did not have a significant impact on the market interest rates. Therefore, the State Bank has not selected operation target as price. In fact, in the monetary policy management, the State Bank primarily aimed at regulating the money supply annually approved by the Government for the purpose of foreign currency purchase, refinancing for commercial banks and other purposes. With such a way of operation, the State Bank has already selected operation targets by volume. Since 1995, the State Bank has identified and regulated money supply by SBV to increase annually to stabilize currency according to the expected norms. This volume of additional money supply was determined on the basis of growth of total liquidity (M2), consistent with the GDP growth and anticipated inflation rate and money multiplier of credit institutions.

After the Prime Minister had approved the additional money supply each year, the Governor of the State Bank managed the money supply within the volume approved by government through management of the monetary policy tools. With such a way of operation, the State Bank, in fact has: (i) impacted on foreign currency assets of the State Bank when the State Bank performed foreign currency trading on the interbank foreign currency market, (ii) impacted to change in net domestic assets when the State Bank refinanced commercial banks and performed other purposes, such as State Budget lending according to government order. This action of the State Bank has impacted to change the MB, through which affected to the MS. However, in the money supply operation, the State Bank has not controlled all factors, which can change MB as mentioned above.
MANAGEMENT OF TOOLS OF MONETARY POLICY PERIOD 2000 - 2010

Period 2000-2003

In 2000, to carry out the tasks of economic development in the context of in 1999, domestic economic growth lowered at 4.8%, the economy had sign of deflation (inflation in 1999 was 0.1%), activities of the commercial banking system had many difficulties. Facing this context, the State Bank set the target for monetary policy management in 2000 was to make a prudent loose monetary policy to ensure objective of stability of money value, inflation control no more than 5%, contributing to economic growth, and carrying out the government’s stimulus policy, continuing to stabilize banking system. In general, in the period of 2000-2003, the domestic and international economic- monetary evolutions took place not so complicated, the operating monetary policy stick to targets, so the result was that CPI was controlled at low level24, economic growth had gradually increased over the years.

Period 2004 – 2005

The government set a target of high economic growth to accomplish socio-economic development target of 5 years 2000-2005 (average 7-7.5 % per year); in 2005, growth target was set at 8-8.5 % and inflation index under 6.5%.

Meanwhile, the domestic and international economic situation had many adverse and unpredictable fluctuations. The objectives of monetary policy set in these 2 years were "monetary stability, inflation control, without impact on economic growth targets". The State Bank used open market operations (OMO) as a main tool to operate monetary policy to stabilize interest rates, stabilize currency, actively support the implementation of objectives of economic growth , inflation control according to targets set by the National Assembly. At the same time, the solution for operation of monetary policy had an important role to maintain monetary stability in 2004, 2005 and achieved a high growth rate (7.79 % and 8.44 %) with policy of stabilizing VND against USD. The Governor of State Bank committed to people that of VND would not decrease over 1 % per year. This commitment was a temporary solution, which had

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24Inflation (CPI) 200: -0.6; 2001: 0,8 2002: 4%;2003: 3%
great impact on public sentiment and investors. However, in the long term, if government used intervention measures to commit to keep the stable exchange rate, this would have had a negative impact to the development of foreign exchange markets and no export promotion. But in such a complicated situation, in order to achieve the objective of monetary policy, the policy of exchange rate stabilization was a reasonable choice. Supporting for the exchange rate stabilization policy was the solution of interest rates and reserve requirement. Specifically, in 2005, the State Bank had adjusted to increase interest rates to curb credit growth, simultaneously to ensure that VND deposit was more profitable than foreign currency deposit, reducing the pressure to shift from VND to foreign currency.

**From 2006 to mid-2007**

In context of that usable capital of Credit Institutions was abundant due to surplus funds from overseas, and especially in 2007, when inflation tended to come back, in management of open-market operations, the State Bank moved from bid primarily to sell mainly.

**From mid-2007 to September of 2008**

In the context of big increase in consumer price index, the State Bank implemented prudent monetary policy to control total liquidity at a reasonable level, in addition, monetary policy tools were flexibly executed and cooperated closely to reduce the money in circulation, control credit growth. Monetary policy is operated to be easing to promote economic growth, control inflation and ensure the safety of the system.

In 2007, in order to achieve the objective of tightening monetary, Open Market Operation (OMO) was operated flexibly, closely following objectives to operate monetary policy and implementing money withdrawal from circulation. At the same time, the State Bank kept interest rate (base rate 8.25% per year, refinancing 6.5% per year, discount 4.5% per year, etc...) and reserve requirement ratio to stabilize the market interest rate. In addition,
State Bank actively intervened to buy - and sell foreign currency and carry out the floating exchange rate regime under control to avoid the price up of VND and to make the exchange rate between VND and USD in the market increased in low level.

In the first 7 months of 2008, in the context of inflation and trade deficit threatening macroeconomic stability, implementing direction of the Government, the State Bank has synchronously implemented the measures prioritizing to curb inflation, stabilize the macro-economy, maintain economic growth at a reasonable rate and ensure social security. Specifically,

State Bank has: (i) actively withdrawn money from circulation, through the following measures: increased required reserve ratio by 1%; issued VND 20.300 billion required Treasury bills. At the same time, they had in time supported short-term loans to credit institutions having difficulty in liquidity, through open market operations and short-term refinancing implementation, especially joint-stock commercial banks with small scale; (ii) increased the base rate from 8,75- to 12-14% per year, the refinancing rate from 6,5-7,5-13-15% per year, rediscount rate from 4.5% -6-11-13% per year.

Since the end of July, 2008, despite of positive signs of the macroeconomic such as inflation and the trade deficit tended to decrease, economic growth tended to slow down. Under the guidance of the Government, the State Bank continued to manage tightening monetary policy but flexible in operation and loosened from October of 2008. Specifically: (i) adjust required Treasury bills interest rate from 7.8% per year to 13% per year (in July), (ii) three times increased reserve requirements interest rates from 1,2 to 3, 6 to 5 to 10% per year (in August, September, October) and decreased to 9% (in December), (iii) from October to December of 2008, decreased 4 times the key interest rates such as the base rate from the 14-13-12 -11-10% per year, the refinancing rate from 15-14-13-12-11% per year, discount rate from 13-12-11-10-9% / year to help credit institutions reduce lending rates, (iv) decreased the reserve requirement ratio for deposit in VND from 11-10-8-6% and decreased the reserve requirement ratio for deposits in foreign currency from 11-9-7%; allowed Credit Institutions to use required Treasury bills for the refinancing transaction and pre-term liquidation if in demand, and (v) step by step expanded amplitude of USD buying - selling rate of credit institutions from +0.75% to +1%, +2%, +3% Compared to
the interbank average rate; and at the same time, operated interbank average rate towards gradual increase, in compliance with the demand - supply of foreign currency in the market and aimed at supporting export, restricting trade deficit, not allowing CIs to buy, sell dollars through other currencies.

**Period 2009-2010**

In 2009, the financial crisis and global economic downturn happened complicatedly, and had negative impact on the many countries’ economies, including Vietnam. The domestic economic met difficulties; the macro-economic balance was actually not solid; quality growth and competitiveness of the economy was low, though, thanks to synchronous implementation of stimulus solutions, economic downturn has been prevented; macroeconomic basically has been stable; economic growth reached 5.2% in 2009; inflation was controlled below 7%, social security was guaranteed. In 2009, the operating monetary policy solutions, credits, and exchange rates which are used to prevent economic recession and to stabilize macroeconomic include:

- **Operating monetary policy instruments, in conformity with the happening of market and monetary policy objectives**: (i) the base rate, the refinancing rate, and discount rate fell respectively 7%/ year, 7%/ year, and 5%/ year from February 2009 and remained unchanged at the end of November 2009; From 01/12/2009, base rate being adjusted to increase; refinancing rate and discount rate increased respectively to 8%/ year, 8% /year and 6% year; issuing interest rate agreement mechanism of credit institutional for lending capital needs to serve people’s lives, lending through issuance and use of credit cards; (ii) adjusting to decrease the reserve requirement ratios for VND non-maturity deposit and VND deposit with maturity being below 12 months from 6% to 3%, VND deposit with maturity being above 12 months from 2% to 1%; and (iii) operating flexibly open market operations, refinancing loans to control the money supply, ensuring security of payment system, and stabilizing the monetary market.
- Operating exchange rate instruments, combination with the foreign exchange management and appropriate foreign exchange market intervention: (i) the exchange rate increasing from +3% to +5% (24/03/2009) and being adjusted to decrease +3% (26/11/2009); (ii) operating the average exchange rate of interbank market by increasing, on 26/11/2009 it increasing to 17,961 VND, consequently the exchange rate ceiling of the commercial banks was 18,500 VND/ USD ( an increase of 3.43% comparing to that of 25/11/2009); (iii) foreign exchange intervention being used to meet demand for imports of essential commodities and to lead commercial banks to have negative foreign currency being above 5%, and (iv) with regard to gold prices situation skyrocketing in early November 2009, the State Bank of Vietnam has announced mechanism to facilitate for enterprises to import and export gold to balance supply and demand, and to stabilize domestic prices.

- Implementing asynchronously interest rate support mechanism for short-term, medium and long-terms loans by VND according to No.131/QD-TTg on 23/01/2009, Decision 443/QD-TTg on 4/4/2009, Decision No.579/QD on 6/5/2009 and Official Dispatch No. 670/Ttg- KTTH on 5/5/2009 of Prime Minister, going together with enhanced inspection, monitor, and perfecting the mechanism and removing the obstacles related to interest rate support mechanism.

- Controlling credit growth at a reasonable rate, density and structure, ensuring the credit quality through operating flexibly monetary policy instruments, controlling strictly loans to non-manufacturing sectors ( securities trading, real estate, consumer loans, etc...), adjusting to decrease the maximum rate of use of short-term loans for medium and long-term loans from 40% to 30% of commercial banks.

With the economic recovery in late 2009, the authorities have adopted tight monetary policy and priority changes from growth to price stability. November 2009, the State Bank of Vietnam increased base rate by 100 points (1%), continued to decrease exchange rate by 5.5% and terminated the interest rate support program for short-term loans.

As mentioned above, in recent years, due to performing multi-objectives, the monetary managers have faced many difficulties in balancing the many tasks assigned which were likely to
contradict with each other in which these is the supporting recovery of economic growth and price stabilization, this is well illustrated by operating monetary policy in 2010.

The targeting macroeconomic stability, control of inflation and economic growth in 2010 has changed in a short time so that the task assigned to the State Bank of Vietnam has also changed. Specifically, from April to December 2010 (Resolution 18/NQ-CP on 6/4/2010, Resolution 23/NQ-CP on 7/5/2010, Resolution 39/NQ-Cp on 4/10/2010), The State Bank of Vietnam has been assigned a task in operating to decline the market interest rate, and contributing economic growth. To achieve this goal, the State Bank has operated the monetary policy instruments combined with a number of administrative measures. In the first three quarter of the year, base rate and refinancing rates remained unchanged at 7-8% / year, reserves requirement for deposits in foreign currencies was adjusted to decrease from 7% to 4% for maturities being less than 12 months, from 3% to 2% for the maturities being above 12 months, open market operation was operated with large quantities, the interest rate was adjusted to decrease, volume of refinancing loans was increased, overnight loans and swap with commercial banks was to regulate the decline of interest rate according to direction of the Government in Resolution No 18/ NQ-CP; implementation of the interest rate agreement mechanism for VND from April 2010.

In operation, the State Bank of Vietnam also directed the Credit Institutions to implement the expansionary credit with strict control of credit quality; to focus on the agriculture, rural, export, small and medium enterprises; to adjust the average exchange rate of interbank to increase to 18,932 VND/USD (going up by 3.36% in 11/02/2010, going up by 2.1% on 18/8/2010, total being 5.52%); Implementing the solutions of controlling strictly gold market at the beginning of year. Closing the gold trading floor and terminating gold trading on account in abroad; operating gold exports and imports in conformity with market demand; monitoring closely the movements of monetary markets and performing the solutions to ensure security system. Supporting liquidity for commercial banks; promulging new regulation in accordance with the practice, international standards and the actual conditions of our credit institution system about safe ratio; permitting the establishment and operation of joint stock commercial banks, merger, consolidation, acquisition of credit institutions, business management of commercial banks; extending the increasing progress in the charter capital of credit institutions under Decree
141/2006/ND-CP until the end of 2011; supervisory agencies, State Bank of Vietnam’s branches in provinces and cities strengthening in inspecting and examining credit institutions.

Monetary policy adjusted toward loose has been continued until 3/2010, even as inflation continued to escalate. In the fourth quarter of 2010, with regard to rising inflation, the Government issued Directive No.1875/CT-TTg of the Prime Minister on 11/10/2010 to provide the solutions to stabilize prices and market in the last months of 2010, the Directive No. 2164/CT-TTg on 30/11/2010 was about to continue to boost production and to ensure balance between supply and demand for goods and services, price and market stability in Lunar New Year and in the first quarter of 2011.

From November 2010 (Resolution No.44/NQ-CP on 9/11/2010), the key task of the State Bank of Vietnam was to operate monetary policy following to market signals to enhance the control of credit outstanding balance growth rate and total payment instruments, which helped to control inflation. The State Bank of Vietnam has adjusted to increase by 1%/ year for operating rate such as refinancing rate, discount rate, to go up by 1-2% for interest rate in open market operations; direct all credit institutions to fixe deposit rates by being no more than 14% USD/ year. However, interbank’s interest rate increased to 18-20% after base rate rose, the State Bank of Vietnam has intervened by injecting more liquidity and reducing the heat of interbank market. Although the inflation rate in November 2010 was higher than that of expectation, but the State Bank of Vietnam maintained the base rate at 9% until the end of year. These movements show that the operating rate of State Bank of Vietnam has not yet been suitable to the macroeconomic movements to regulate the monetary market which relies on the policy of declining market interest rates as direction of Government to give priority to economic growth.

**Evaluation of operating monetary policy instruments in period of 2000-2010**

The reality shows that the State Bank of Vietnam has gradually shifted from the use of direct instruments to indirect instruments. However, the indirect instrument is not effective in regulating the money supply. Specifically as follows:
Operating interest rate is the most inadequate issue at present

In term of implementation of interest rate agreement mechanism, in order to ensure stable market rates, in 2003, the State Bank of Vietnam has gradually formed the interest-rate frame orienting to market interest rate. Accordingly, the refinancing rate was gradually adjusted to act as interest rate ceiling of interbank market; the discount rate was adjusted towards the interest rate floor. Along with adjusting the discount rate to become the interest rate floor, the State Bank has allocated discount limits for all banks. Thereby, the discount would be operated as a regular funding channel with low rate from the State Bank of Vietnam. Meanwhile, loans secured by the pledge of valuable papers applying the refinancing interest rate is interest rate ceiling for the State Bank of Vietnam to implement gradually as the lender of last resort in the interbank market.

The refinancing rate and discount rate was defined at different levels, but these instruments was used for mortgage and discount loans; as well as the access mechanism of two forms of refinancing still have similarities. Thus, these two types of interest rates have not yet really promoting the role of creating the fluctuant frame of interest rate on the interbank market. The relationship between the refinancing rate, discount rate and market interest rate has not yet been closely. The change in these interest rates of the State Bank of Vietnam had a limited impact on demand for loans of commercial banks. We will further analyse this issue in the following section.

When the interest rate of the economy was liberalized, it has required the State Bank of Vietnam to regulate indirectly interest rate through the use of monetary policy instruments. The

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25The steps of liberalization of interest rates or significant milestones in operating interest rates in Vietnam include: (i) before June of 1992: implementing specified interest rate, (ii) from June of 1992 to 1995: implementing mechanism of positive interest rates, interest rate had been managed under framework of ceiling and floor rates, (iii) from 1996 to ahead of August, 2000: eliminating ceiling interest rate, operating under mechanism of the basic interest rate plus amplitude, (iv) from June of 2002 to May 19th, 2008: negotiable lending interest rate, (v) from May 19th, 2008 to February 25th, 2010: ceiling lending rate; (vi) since January 23rd, 2009: negotiable interest rates for loans to requirements for life, business loans through the issuance and use of credit cards, (vii) from February 26th, 2010: base rate and the mid-term, long-term loan with negotiable interest rate, and (viii) from April 19th, 2010: implementing completely negotiable interest rate mechanism.
interest rates of the State Bank of Vietnam must have impact on market interest rates and have strong relationship with market interest rates. In other words, the decision about increasing or decreasing the interest rate is considered a signal that the Central Bank wants to deliver to market in which it means the Central bank will tighten or loosen monetary policy. However, with current operating mechanism, the interest rate levels of the State Bank of Vietnam are not really market signals that impact effectively on other macroeconomic policies. A part of interest policy, such as interest rate of treasury bonds, interest rates of state credit that favour policy subject under the decision of Ministry of Finance. Furthermore, in fact, after the liberalization of interest rates along with the elimination of interest rate ceiling, performing the interest rate agreement loans from May 2008 to now, the State Bank of Vietnam has used administrative measures to approve the prescribed the ceiling of deposit and lending rate.

The State Bank of Vietnam has not chosen the decisive interest rate and built the operating mechanism, the method for determining the interest rates of State Bank of Vietnam (including refinancing rates, discount rates, open market rates, interest rates) to ensure tight relationship between the central bank’s interest rate, Treasury bill rates, and market interest rate. Therefore, interest rate movements of State Bank of Vietnam have insignificant impact on market interest rates and have not yet really played the role of market orientation. This is because of the controlling volume objectives in which the State bank has not enough “power” to intervene the market through refinancing loans when the market has strong volatility of interest rates to stabilize interest rates. Specifically, in the process of controlling and regulating monetary, the role of discount and refinancing instruments has its limitations. Refinancing instruments doesn’t really act as a state bank’s instrument to provide short-term funds and to offset the provisional shortfall in payment of commercial banks in which it shows that this operation does not take place regularly while the number of commercial banks participating the refinancing is not much. Although the refinancing mechanism has no discrimination between banks, though, in fact, the State Bank of Vietnam still primary performs refinancing for state-owned commercial banks. The commercial banks with low privatisation are refinanced because they don’t have enough conditions to refinance. The regulating monetary through refinancing in each period has not yet clear orientation which is whether it is regulated by interest rate or by volume. Volume for
discount loans is low, so that when commercial banks have surplus capital and repay discount loans, low amount of money received has not really impact the supply, demand and market interest rates. Especially, base rate has not promoted the effect.

_The open market operation instruments_

Since the opening on July 2000, open market operation (OMO) has been constantly improving and becoming primary instrument of the State Bank of Vietnam that is used to regulate monetary. Through the implementation of the two-way trade in buying and selling of valuable papers with credit institutions, open market operation has contributed timely adjustment of disposable capital of credit institution, which extracts surplus disposable capital and supplement to shortfall disposable capital. In fact, in addition to support capital to credit institution which has shortfall disposable capital, The State Bank of Vietnam has offered valuable papers to attract surplus disposable capital. Transaction methods include short term and long term transaction and lump sum transaction. The decision about selecting the trading method is made flexibly depending on the target of monetary policy in each period. Besides, the term of transaction is also diversified in accordance with regulating disposable capital needs of credit institution. The operation of OMO is increasingly more marketable. According to regulations, auction methods including volume and interest rate bidding; approving unified interest rate or individual interest rate. However, in the transactions of OMO since 2002 to this day, the State Bank of Vietnam mainly implement the bidding with interest rate bidding and individual interest rate methods which force credit institutions to consider bidding interest rate.

Although the target of open market operations is to regulate daily disposable capital of credit institution, and sometimes it is limited by money supply, instrument’s ability to regulate has its limitation. This instrument regulates through bidding, but the advantage in bidding belong to commercial banks which hold many valuable papers, but has not really lack of funds. The small commercial banks have more difficulties in accessing capital of central bank, or have to engage with high interest rates to win a contract, or borrow from larger banks which win a contract with high interest rate so that it distorts market information.
Operating open market operation has some limitations such as: (i) commodity market has not diversified about types and duration in which it mainly is treasury bills (mostly maturity being 364 days) and state bank treasury; (ii) participants of open market operation mainly are state-owned commercial banks; (iii) the levels of interest rates of OMO established at bidding are not fully formed by the relationship between supply and demand. In many cases, the State Bank also intervene market interest rate by raising the interest rate announcement, fixing at the moment that market interest rate exceeds the desired limit of the central bank.

*Reserve requirement*

After the Law on the central bank was born, the central bank has taken steps to adjust basically to the reserve requirement instruments. Accordingly, the subject must implement the reserve requirement including: all credit institutions operate under the Law on Credit Institutions; the reserve requirement ratio is from 0-20%; the reserve requirement deposit must be deposited in central bank; the amount of reserve requirement is calculated by average outstanding balance of deposit in the maintenance period. From 2000 to now, the central bank has continued to implement the regulation on the average reserve requirement for: (i) increasing the ability of central bank to control monetary, through fluctuant outstanding balance deposit of credit institution in central bank, the State Bank being able to predict the demand for reserves of credit institution to decide whether it is suitable to withdraw or inject money; (ii) enabling the credit institution to use the fund to be more flexibly and effectively. Besides, the reserve requirement ratio was adjusted to be more flexibly in accordance with the objectives of monetary policy and monetary developments in each period.

Besides, the reserve requirement instruments being to regulate money supply also has a few limitations: the regulation on reserve requirement has not cover the entire amount of money in the economy so that it has limited ability to control the money supply of SBV through this instrument. Although the central bank has expanded the deposit that is required to reserve for deposits from 12 months to 24 months, and now for all the deposits of customers, though, a number of other deposits such as deposits of credit institution, registered mutual fund, and mandatory funds has not performed the reserve requirement. In the context of international economic integrating to be more deeply at present, the Vietnam’s ability in borrowing from
abroad as well as attracting capital investment is increasingly developing, so that the deposits that are not required to reserve are growing and have significant impact on the monetary circulation in Vietnam. However, up to now, this kind of monetary has not been required to reserve, which have partial influence on the ability of controlling monetary of reserve requirement instrument.

**SWAP**

This professional operation has been used since July 2007 in Vietnam. Through this operation, the central bank has pumped Vietnam Dong (VND) to support credit institutions that meet temporary difficulties about disposable capital in VND, and to achieve the goal of monetary policy. However, the State Bank doesn’t encourage commercial banks to access the capital of State Bank through this channel which commercial banks can only use when it is absolutely necessary. Therefore, SWAP rate is set at relatively high interest rates comparing to that of interbank market. In fact, this instrument is only effective during the time when the commercial banks really scarce disposable capital in VND, especially the foreign banks with surplus foreign currency but lack of capital in VND doesn’t hold short-term valuable papers so that they don’t have conditions to access to other funding channel of State Bank.

**TRANSMISSION MECHANISM OF MONETARY POLICY**

As mentioned above, there are four channels whereby monetary policy affects the economy of the region, including: interest rate channel, credit channel, asset price channel, and exchange rate channel. As can be seen, in the monetary policy of State Bank of Vietnam, the target system of monetary policy has been built; though, the transmission mechanism between the target systems has not been clearly defined. In particular, the objective system of monetary policy including ultimate objectives, medium-term objectives, and operational objectives has not been defined. The relationship between the objectives is not close. State Bank of Vietnam does not have enough necessary conditions to monitor, capture timely the interactions between the variables. In
the operating monetary policy, the State Bank is being driven by a number of non-market factors in which the monetary policy instrument has not guaranteed that inherent role of regulating monetary is correct. Because of a transmission mechanism being not clear, operating monetary policy of the State Bank is limited in pursuing goals.

Evaluating the situation of the transmission mechanism of monetary policy of the State Bank shows that, in the 1990s and early 2000s, interest rate and exchange rate channel has limited role in the transferring the effect of monetary policy to economy. Impact through interest rate channel is still insufficient (the relationship between interest rates of State Bank and market interest rate being not tight and unclear). The impact of monetary policy is mainly performed via money supply and credit for the economy. This is also suitable to conditions of monetary market and capital market in Vietnam which has not really developed, commercial banking system is still limited, the economy of our country is partly dollarized and is in transition, international integration. However, as the discussion and actual results above, it indicates that the relationship between monetary variables such as board money (M2), the credit of banking system for the economy with macro variable is not really close. The State Bank pursuing the medium-term objectives of M2 growth, credit growth, followed by the ultimate objectives such as controlling inflation, supporting economic growth still meet difficulties. In general, the impact of monetary policy and money supply via credit has certain limitations.

Some results of research and reality in Vietnam recently show a clear change in the impact of monetary policy on the economy through the channels in this decade comparing that of 90s. Accordingly, the impact of monetary policy through the interest rate channel is increasingly clear (impact on saving behaviour, individual consumption and enterprises, which will affect aggregate demand, economic growth, and inflation). The impact of monetary policy through the credit channel tends to decrease while through exchange rate channel becoming stronger; and through asset price channel still being feeble; though, the development of stock market from 2006 to recent years has become stronger. These considerations are clearly illustrated in the context of macroeconomic in the year of 2008-2010 about quick reaction of market with regard of movements of operating monetary policy of State Bank.
GENERAL REVIEW OF MONETARY POLICY IN VIETNAM PERIOD 2000-2010

Some achievements

In period of 2000-2010, the monetary policy management of the State Bank had continuously improved. Monetary policy management was gradually innovated in determining objectives of monetary policy, the management and operation of money supply mechanisms, currency regulation through choice to use the tools of monetary policy at the same time. The objective of monetary policy aimed at stabilizing monetary, curbing inflation, make stable environment to promote economic growth and ensure the safety of the system.

State Bank shifted from direct tool to indirect tool to enhance the effectiveness of monetary policy, the monetary policy tools have been set up and gradually improved in accordance with international practice. So far, the State Bank's monetary policy was run through the use of system of tools, such as reserve requirement, open market operations, rediscount lending operations, refinancing and currency swap operations (SWAP).

The banking system’s Capital mobilization has continually been promoted, funding to meet the objectives of investment and development for the country. Business activities of CIs continued to grow, which contributed positively to the objectives of curbing inflation, stabilizing macro-economy, ensuring social welfare and sustainable growth.

Shortcomings and limitations of monetary policy and the cause

With the trend of deeper integration into the world economy and diverse development of the market economy, the economic – currency transactions has become more complex, then the operation of the monetary policy of the State Bank had the following shortcomings and limitations:

*The ultimate goal is not clear, no preferences*
Under the request of the government, The State Bank’s policy management activities had to pursue so many objectives such as stabilization of currency value, inflation control, economic growth and so on ... In fact, there’s conflict among the goals, if giving priority to the inflation control target, the State Bank needs to sacrifice economic growth target, they cannot accomplish both objectives simultaneously. Because SBV has not clearly defined operational objectives, at some point of time, this had some impacts on the State Bank’s planning and operation of monetary policy, monetary policy was sometimes passive and slowly responded to market changes.

- State Bank had not clarified transmission mechanism of monetary policy impact. The clarification of transmission mechanism has important implication to the monetary policy management. Clear transmission mechanism may allow State Bank to have right decisions in running monetary policy tools, towards expected objectives. In fact, the State Bank has not had the specific quantitative analysis of impact degree of change in State Bank’s money supply to the ultimate objective of the monetary policy, and how these changes in money supply affected the credit of the economy, the total liquidity, interest rate or exchange rate etc... The un-identification of transmission mechanism has somewhat limited the State Bank’s decisions when the market has fluctuations.

- The system of monetary criteria of the State Bank was not really clear to convey the impact of the policy decision to operational objectives, intermediate objectives and ultimate objective of monetary policy. Specifically: (i) the impact of M2 to the variables of the economy was unclear. Evolution of the total liquidity M2 with the meaning of intermediate target was not consistent with economic growth and inflation. The State Bank did not actively take full control of M2 (as analyzed above) as well as the actual M2 growth rate, (ii) the correlation between money supply and inflation in Vietnam was also unclear. In fact, we would like to control inflation, but it’s hard to even control the money supply; (iii) in the forecast of total amount of money affected to money supply (MS) and credit of the economy, the State Bank considered the Monetary Base (MB) as operational objective, but in the running
process, SBV only regulated some factors affecting MB, not the whole MB. In fact, they just regulated the amount of money the government allowed to provide in the year, not yet operating MB gain – The actual amount of money supply to the economy (the amount of money have impact on economic growth, inflation and system stabilization).

- *The ability to regulate the market conditions such as the money supply, interest rates was limited*, low efficient, this was because the State Bank had not controlled the entire flow of money in the economy such as foreign exchange in / out flow of the country, lending activities by other financial institutions, the revenue and expenditure budgeting and banking activities of other organizations.

- *Operation of the monetary policy tools was not highly effective* due to that selecting, using, identifying basic functions of each monetary policy tool to properly run operational objectives was limited. The operation of money supply was passive by the money supply for appointed targets of the Government. The selection of mainstream interest rate and setting up interest rate management mechanism was still in the phase of research and experiment.

- *The management of the State Bank’s monetary policy was so administrative*. This is most clearly demonstrated through the handle of monetary tightening to fight inflation in the early months of 2008, the later months of 2010 and 2011. In 2008, to tighten monetary, fight against inflation, the Governor requested commercial banks to set interest rate to be positive (higher than expected inflation) but this requirement was very inconsistent. Because there had requirement that interest rate must not exceed 12% per year, while actual inflation reached 9.2%, through only 3 early months. Not only that, Vietnam Banking Association advocated commercial banks to accept the highest interest rate of 11% per year through meetings. With regulation of maximum interest rate of 12% per year, and the so-called interest rate agreement of the Banking Association pushed the small commercial banks to the situation that they
could not raise funds from residents but shifted to purchase capital from major commercial banks in the interbank market with interest rates up to 18-24% / year. In addition, small banks could not approach to refinancing loans from the State Bank. All this lead to extreme difficulty in liquidity for banks. It can be seen this is a major failure in monetary policy of the State Bank. In the late months of 2010 and 2011, the State Bank imposed a VND deposit interest rate not exceeding 14% / year, while maintaining a ceiling USD deposit interest rate of 2%. Motivator of this policy is to reduce lending rates by limiting the bank’s capital cost (and deposit interest rates competition among banks). In fact, the ceiling deposit interest rates did not help to reduces lending interest rates, but led to many significant negative impacts on the banks and financial sector.

- **Monetary policy was mainly in short-term.** Although 5-year banking operation plan and 10-year vision for banking development strategies were imposed, strategic long-term orientation on the monetary policy management had not been clearly and scientifically developed based on the basis of quantitative analyses due to the information system and database had not been completed.

The cause of the limitations of monetary policy management:

- The intensive dominance of government decreased the independence, autonomy of the State Bank in flexibly conducting monetary policy.
- **The money market and bond market developed in a low level, lacking of dynamism,** flexibility, did not reflect supply and demand of capital, the market tools were limited and inefficiently used, which in consequence limited the ability to regulate the currency of the State Bank through the tools of monetary policy. The currency market also has cleavage, with no tight coordination among banks: Some CIs were in shortage of VND capital to ensure liquidity, still could not access loan from banks in sufficient of capital because these banks provided a certain credit level for other banks to borrow. Simultaneously, the attitude and the ability to link the systems of various CIs for supporting each other to ensure payment safety were weak; even though some banks took advantage of tough
times for unfair competition, pushing up interest rate. Therefore, at some points of time, the liquidity in the whole system was abundant, in principle; the State bank needed to withdraw money. However, in reality, the State bank still had to support capital for some CIs to maintain monetary stability. The State bank then faced difficulty when making the final regulatory role in the market. In other words, the inefficient money market was an instrument for the State Bank to adjust the total amount of the money in the economy; had not created payment ability for the business, interest rate in the monetary market could not be used as the interest rate reference for pricing other debt assets. This was due to the lack of a clarified information system in accordance with people’s awareness and the ability to access. The system information among state agencies, between the state agencies and companies still faced many difficulties, which indeed affected the policy decisions, and monetary market regulation. The legal basis for the operation of market tools had not been fully issued. There was a lack of regulations to enhance the liquidity of the valuable papers and limit the commercial banks to issue new tools. Although recently the State bank has opened a number of new tools for commercial banks to apply, such as SWAP interest rate, Option business (pilot), but generally there were not many tools. Additionally, the market was still unfamiliar with new tools. The governance of some commercial banks was still poor. Interbank currency market lacked the tools and the existing tools were also not complete, along with the fluctuation of foreign currency flows which led to the quiet operation of the market. Government bond market had not provided the benchmark interest rate curve to serve as a basis for determining the interest rates for other financial assets.

- The Vietnam commercial banking system joining the integration still lacked of capability of risk management, management of assets and liabilities. The commercial banks were in restructuring phase, therefore having great disparity in scale, asset quality, financial strength and competitiveness; the ability to adapt to the market fluctuations was weak, thus limited the effectiveness of monetary policy. Many CIs did not pay much attention to liquidity management, not yet or did not own valuable papers to reserve liquidity; many CIs used short-term capital or even borrowed capital
in the interbank market for lending the economy. Therefore, when the market fluctuated, they easily faced liquidity difficulty. In the situation the money market has not had a smooth cash flow; the above factors also caused certain limitations to the State bank’s monetary regulation ability through monetary policy tools. For example, in the early months of 2008, some small commercial banks did not have enough valuable papers to participate in open-market operations, and had to borrow from the interbank market with high interest rates when lacking of temporary usable capital, causing turmoil in the currency markets.

- **The financial capacity of the credit institutions was limited; CIs were still in the process of restructuring and launching project of modernizing the payment system.** The management of online centralized capital in the system remained difficult. Many CIs have not monitored and analyzed capital stream flow by term, so capital management capability was limited. Business administration, the ability to adapt to changes of the market was still insufficient; business objectives focused too much on scale and profitability, depreciated and not strictly complied with the regulations to ensure payment safety. The joint stock credit institutions moved from rural areas, with small scale, unprofessional staff, but set the business growth beyond business administration and quality of human resources, having high risk, especially the risk of liquidity, causing fluctuations in currency markets.

- **The dollarized economy has limited the effectiveness of the neutral intervention by the State Bank.** When the flow of foreign capital reached high, exceeding the need for financing current account deficit, creating a large amount of excess foreign currency excess in the market, the State bank enhanced buying foreign currency to increase state foreign currency reserves, which means putting the local currency out. In 2007, when foreign exchange reserves were accumulated twice as much as the level of foreign exchange reserves at the end of 2006, State bank made neutral intervention through open market and neutralized about 90% of the money supplied. However, the monetary data (see Table 4.4) shows that, in 2007, M2 grew by 46% and credit grew
over 50% in comparison with the end of 2006, indicating that when the economy was in dollarization, the ability to control the currency had more difficulty.

- **The coordination between monetary policy and other macroeconomic policy remained loose**, lacking an information system connecting market prediction section and other ministries. The co-operation with the ministries to forecast macroeconomic, foreign capital inflow was not well-done. The information system for policy planning was weak and not in time. In recent times, the coordination among the ministries has improved but still not really in sync. The shortcoming in information exchange among ministries in charge of macroeconomic management such as the Ministry of Finance, Ministry of Planning and Investment, the Ministry of Trade and Industry, etc…with the State Bank has had a certain impact on the consistency between monetary policy and macro-economic policies, thereby reducing the effectiveness of monetary policy.

In fact, the monetary development of government sector is one of the factors affecting the money basis (MB) and often has a major impact on the amount of money basis of the State Bank. Generally, the amount of money into (or out of) the economy from this channel is relatively large, sometimes the level of impact of this channel reversely changed the trend of impact of the State Bank, affecting the objective of monetary management of the State Bank. Therefore, close coordination between monetary policy and fiscal policy is one of the key points to efficiently operate monetary policy. However, it is said that there hasn’t had a close coordination in policy management, particularly in the currency and inflation control between the Ministry of Finance and the State Bank. The amount of money given or collected from the economy is conducted not only by the State Bank but also through the revenue and expenditure of the Ministry of Finance channels such as the State Treasury, Development Assistance Fund (Development Bank), insurance companies, these various money supply channels are beyond the State Bank’s monetary control.
In the past time, especially in 2010 (along with the issuance of Circular 13 of SBV), the issue that State Treasury maintained deposits in the State Commercial Banks (SCBs) which raised controversy.

The fact that commercial banks use Treasury deposits for lending in our country has increased the liquidity of the banking system and loans in the economy, and thereby increased the total liquidity. Since the State Bank hasn’t timely collected information of Treasury deposits at commercial banks, in addition, the Treasury deposits at the commercial banks have had large fluctuations, which led to State bank couldn’t not accurately predict the amount of liquidity in the banking system, thus couldn’t control the scale of the total liquidity. In detailed, according to the State Bank, in 6 early months of 2010, total Treasury deposits in VND in the banking system was about VND 77.8 trillion, while deposits at commercial banks was about VND 51 trillion, accounting for over 65% of the total outstanding Treasury account. It can be said that Treasury deposit is an extremely large fund and is frequently volatile because of their no-term feature.

In addition, the Treasury deposits at commercial banks can create many other negative impacts on monetary policy when the Government issues bonds and commercial banks use these deposits to purchase government bonds. The Government’s objective of raising capital through the bond issuance is to compensate the budget deficit and the deposits aimed at must have been the idle capital of the economy. However, government bonds usually accounted for a large proportion of the assets of the bank and the bank's capital invested in bonds might be the state’s capital deposited in commercial banks. Commercial Bank can use this source to buy bonds, and then discount the bond at the State Bank to obtain loans for the economy. The Treasury deposits at commercial banks became money to form a mechanism similarly to the mechanism of creating money, but did not derive from the State Bank’s intention. Moreover, it may cause competition phenomenon between fiscal policy and monetary policy, bond yields and interest rates on the interbank market can compete with each other to push interest rates high and cause difficulties in the State Bank management. In the current situation, it is impossible to take Treasury deposits out of commercial banks’ loans. However, the State Bank should set a roadmap to take these funds out of the banks’ business capital. In this context, it is clearly necessary to have closer coordination between monetary policy and fiscal policy.
Difficulties in currency forecast: In fact, when predicting M2, the State Bank needed to analyze the factors affecting to increase or reduce net government lending by considering fluctuations on Government’s deposit account and loan account in banking system. Also, the prediction of net government lending is based on budgeting estimation data for annual budget revenue and expenditure plan. State budget (BD) will withdraw or add more money into deposit accounts in the banking system, up to changes in actual budget revenue and expenditure, the level of deficit or surplus budgeting. Moreover, for flexible and timely operation of monetary policy tools, the State Bank should be provided promptly information about actual budget revenue and expenditure as well as plan on budget revenue and expenditure and minimum disbursement every month. However, until now, information provision between Ministry of Finance and State Bank has still had certain limitations. Most of the monthly budget revenue and expenditure figures are estimated data and do not meet time requirements. Consequently, of monetary elements, prediction of net government lending is an unpredictable criterion because the State Bank does not have sufficient information about the state budgeting. For the developed countries, in budget operation, data on implementation and plan often have little difference, so it is easier to forecast this item. For Vietnam, there’s significant difference between budgeting plan and actual implementation, especially difference in plan on investment for capital construction and disbursement. Meanwhile, information about the budget operations of the State Bank was very limited; resulting in forecast of such items was more skewed. In addition, beside the deposit account of the State Treasury at the State Bank, the State Treasury also had deposits at the state commercial banks as mentioned above. This is another difficulty for the State Bank in monitoring changes of government deposits. In fact, it’s hard for the State Bank to predict if State Treasury withdraws from the deposit account at the State Bank or from deposit account at commercial banks for payment of regular expenses and investment in capital construction, etc. ...

When planning the annual money supply, the State Bank forecast impact of the government sector to the monetary developments and estimated money supply on the basis of analysis of the relating factors, including budget estimates, the anticipated budget deficit, sources to compensate budget deficit from domestic and foreign borrowing annually set by the Ministry of Finance. In fact, some years ago, the Government had requested the State Bank to release the money for the
budget to carry out the expenditure tasks of government such as expenditure for capital construction, support for recovery after hurricane, flood, etc... Therefore, SBV had certain difficulties in managing monetary policy due to they cannot predict items for lending Government in such a long term. Furthermore, as mentioned above, beside the accounts at the State Bank, the State Budget also had deposits at the State Bank\textsuperscript{26} and limited information exchange system between the State Bank and the Ministry of Finance is the main difficulty for the State Bank to forecast net government lending in currency balance...

- \textit{Limitations of information systems and databases}: Research results also shows that information system, databases in Vietnam is incomplete and inconsistent in quality: a number of macroeconomic data such as investment, CPI have difference among different sources; CPI data through years has not really reflected inflation level because commodity structure in CPI formula\textsuperscript{27} and calculating methods still have some shortcomings. For GDP growth, there are only figures in quarter from 1999 up to now. For monetary data: statistical system has been in innovation process, statistical scopes have been gradually extended from 12 banks to 24 banks, 36 banks, 72 banks, 81 banks etc. .. Information systems and data as mentioned above make the analysis and comparison based on historical data not really accurate.

The initial research results were only based on collected data sources with low quality and reliability. Analysis and tests have only applied to some factors affecting to implementation of ultimate objective of the monetary policy. Meanwhile, there are many other policy factors and non-policy factors which affect monetary policy operation, but they do not have sufficient condition for analysis and evaluation. For example, econometric model and quantitative analysis of impact of trade policy, fiscal policy, etc. ... to monetary policy operation.

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{26}Under the current regulations, the State Treasury should open a deposit account at the State Bank or State Bank branches, in case there is no State Bank or State Bank branches, the State Treasury account should be opened in state-owned commercial banks (SCBs) and the implementation of opening bank accounts needs to be approved by the State Bank. However, in practice, many problems have arisen in the opening and using of State Treasury accounts at banking system due to adjustment effect of document system is not high, this is because the adjusting documents are separately issued by ministries, while this activity is related to the budget and banking system.
\item \textsuperscript{27}See Appendix of CLI calculating method in Vietnam.
\end{enumerate}
\end{footnotesize}
• Personnel to carry out the analysis, forecast, proposal for monetary policy management was limited: at present, the State Bank has not identified complete econometric models for forecasting monetary demand\(^{28}\), model to determine the impact of changes in interest rates, the exchange rate to growth, inflation, etc....Thus, monetary policy management was sometimes passive and ineffective.

In summary, along with the process of deeper and wider integration into the world economy, the flow of foreign currency into (or out from) Vietnam from exports, imports, foreign direct and indirect investment, etc. ..which fluctuated relatively made operation of monetary policy more complex, requiring the operation of monetary policy to be more flexible and responsive to the volatility of the domestic and international market, to ensure the currency stability, to contribute to inflation control and to promote economic growth.

\(^{28}\) There have had a number of studies on currency demand such as: Tran Tho Dat (2010); Ha Quynh Hoa (2008, 2010); Dang Chi Trung (2004); Pham Quoc Thang (1996); Vo Tri Thanh and Suiwh Leung (1996), etc.
CHAPTER 5
THE POSSIBILITY AND PREMISES FOR INFLATION TARGETING MONETARY POLICY APPLICATATION IN VIETNAM

On the basis of theoretical research, experience given by countries which have successfully applied the framework of inflation targeting monetary policy and practices of monetary policy operation in Vietnam, the research will compare, deeply analyze and evaluate the applicability of inflation targeting monetary policy framework in Vietnam; suggest to set up premises towards the application of inflation targeting (IT), contributing for innovation of the current monetary policy.

THE APPLICABILITY OF INFLATION TARGETING MONETARY POLICY IN VIETNAM

Some judgments about the applicability of inflation targeting in Vietnam

First, inflation targeting monetary policy which was applied in some countries in the world has become more and more effective (reflected through macroeconomic results, the ability of economic shock resistance, etc...) in comparison with the traditional monetary policy (nominal anchor for monetary supply or exchange rate), although the methods of policy operation among countries are not completely the same. However, due to many different reasons, there are about 30 countries around the world applying inflation targeting up to now. This also implies some certain difficulties, challenges when inflation targeting monetary policy is applied. However, discussions between IMF and its member countries in 2006 showed that the number of emerging and developing economies applying inflation targeting could increase 4 times in the coming decade. Therefore, inflation targeting is becoming a significant trend and is an essential transition, particularly in developing countries such as Vietnam.
Second, in a subjective way, since the State Bank pursues the multi-objective monetary policy, and simultaneously uses Total means of payments M2 as an intermediate target, it is more and more difficult for it to control inflation. This is clearly showed through inflation figures in recent years. Inflation increased rapidly but the State Bank has not yet had measures, tools which are really effective in order to curb inflation. Therefore, the State Bank is also aware that it is necessary to find a new anchor for monetary policy that can actively control inflation, stabilize price, maintain inflation at low level and in a stable way and the optimal option is to take inflation targeting as the framework for monetary policy.

Third, in Vietnam, the option towards inflation targeting monetary policy is suitable with the development strategy of Vietnam's Banking system, under which the State Bank of Vietnam will be developed to become a modern Central Bank with two main tasks: controlling inflation to stabilize the currency and making supervision to ensure a healthy operation of the banking system. In fact, in order to prepare premises for carrying out this strategy, the State Bank of Vietnam has prepared and organized researches, surveys on the mechanism of inflation targeting in a number of countries in the world.

Fourth, the point of view of the top leaders of the Government of Vietnam to the correlation between inflation target and economic growth target has recently changed. They realized that economic growth could not rise at all costs. Anti-inflation requires trade-offs. Resolution 11 of the Government affirmed that inflation control, macroeconomic stability are objectives which should be given the first priorities in 2011 and 2012. The innovation point of view paved a necessary and indispensable way to support the application of inflation targeting monetary policy of the State Bank of Vietnam in the future.

Certainly, besides the above mentioned positive premises, whether or not Vietnam now has enough conditions to directly switch into the framework of full-fledged inflation targeting monetary policy is entirely another issue. The analyses in this study show that a country which wants to adopt the framework of inflation targeting monetary policy in a feasible and less challenging way needs to meet the following conditions: (i) price stability is the covering objective of monetary policy; (ii) the approach of the Government to financial resources of the
State Bank is prohibited or restricted; (iii) the State Bank is independent in using its own tools; (iv) the domestic consensus on the importance of inflation target is high; (v) there is a basic understanding of monetary policy transmission mechanisms and relevant ability to affect the short-term interest rate; and (vi) the financial system and the markets perform well.

Experience given by some countries which have carried out inflation targeting also shows that it is not necessary for countries to satisfy all the pre-conditions of inflation targeting framework from the beginning in order to be able to successfully adopt the framework of inflation targeting. In some nations, only some conditions were satisfied, in other nations, some conditions were omitted or could be gradually established from time to time during the implementation process of inflation targeting. Furthermore, the transition process of operating mechanism from the old monetary policy to inflation targeting monetary policy in each country is different. The transition process to IT often begins by the announcement of policy makers about their intention of implementing IT framework. This process will end when most of factors of full-fledged inflation targeting framework (FFIT) are entirely established. Most emerging countries underwent the transitional period before applying full-fledged inflation targeting framework, continued some intermediate mechanisms (implicit inflation targeting or partial inflation targeting) during this transitional period. Vietnam should also apply this experience with the gradual conversion from the current monetary policy mechanism to the monetary policy framework which takes inflation as a target through implicit inflation targeting mechanism.

**Preconditions for successful application of inflation targeting mechanism**

In the context of Vietnam, from our point of view, inflation targeting monetary policy will be successfully adopted if the following conditions are satisfied:

First, price stability must be the top priority objective of monetary policy. Law on the State Bank in 2010 clarified this issue more. During the period when multi-objective monetary policy is still implemented, the priority order in which the number-one goals are controlling inflation, maintaining low and stable inflation should be determined.
Second, the State Bank is completely active in using monetary policy tools. On the operating side, at least the State Bank also has the right to define, decide and regulate the amount of money supply every year and at some point of time, as well as is received and use interest rate and other monetary tools in order to affect inflation target. Among these rights, the State Bank has not yet got the right to decide the plan of money supply now and this plan is made on the basis of decisions from Prime Minister. That Prime Minister assigns this right to the Governor of the State Bank is really just a problem of operational technique. The key point is whether the State Bank can afford to get this right and take its own responsibility or not.

Third, developing a State Bank which is relatively independent of the Government (independent in monetary policy implementation) is feasible. This proposal implies that the premise about institutions for the State Bank to switch into inflation targeting monetary policy is ready. The remaining problem is time.

Fourth, assuming that the State Bank is independent in operating monetary policy; however, this independence is still under certain pressures from the Government if the Central Bank has not been independent in financial activities. Financial independence of the Central Bank is reflected through three aspects: (i) the Central Bank has the autonomy right in deciding the scope and level of funding for the government spending; (ii) Financial resources are large enough to avoid depending on the government allocation; (iii) The Governor has the absolute discretion in deciding most expenditures within the approved budget framework. Among three above aspects, the first one is particularly important.

Fifthly, one of the conditions which contribute to the successful application of inflation targeting monetary policy is that the financial system and financial market need to perform well. However, the competitive capacity of the banking system in Vietnam is still low and contains a lot of potential risks. The capital market and the currency market are still in the early stage of development.

Sixthly, whether the State Bank applies the inflation targeting monetary policy successfully or not also depends on when and how monetary policy and fiscal policy are well combined in reality, not theoretically. Currently, although the coordination between the monetary policy and
the fiscal policy has been implemented in some aspects, it has been just superficial (shown by the incompetence of monetary policy in controlling the interest rate of Government debt instruments; the inefficiency of public spending and budget investment, etc...)

Seventhly, experience of the countries that applied inflation targeting monetary policy showed that inflation rate was falling at the point of time when inflation was successfully curbed in most countries applying the full-fledged inflation targeting (FFIT). Therefore, the policy implementation created the belief for the public in the ability of the Central Bank in achieving low and stable inflation target. Meanwhile, inflation rate in Vietnam from 2004 to now has fluctuated in a complex way, inflationary pressures are more and more increasing. It is clear that the State Bank can not adopt full-fledged inflation targeting monetary policy (FFIT) at the present, but initially, the implicit inflation targeting (implicit IT) can be applied.

Eighth, technically speaking, to offer the framework of inflation targeting monetary policy in a less challenging way requires that the State Bank must be able to be very good at forecasting inflation expectations. However, even calculating the CPI in Vietnam is also limited. The forecasts about price and currency still remain a lot of shortcomings.

THE CONDITIONS OF APPLICATION OF INFLATION TARGETING IN VIETNAM

Selection of the operational objective of the State Bank

To accomplish many goals as mentioned in the previous section, in term of operation, the State Bank selected controlling the volume of money as well as controlling interest rate as the operating objectives, in which the intermediate target was controlling growth rate of M2, credit and interest rate. The selection of the above operating objectives of the State Bank positively contributed to reach inflation and economic growth target as ultimate objectives. However, controlling the growth rate of M2 and credit was very difficult and had not achieved the results as expected because the State bank could not control some other factors affecting M2 such as: the factors causing the change of net foreign asset item (foreign currency flows were in and out
of the country, the economy was dollarized); the change of net government lending item\textsuperscript{29} (changes in revenues and expenditures of the government sector, deposits of the State Treasury in both the State Bank and Credit Organizations); on the other hand, the activities of other organizations which have banking activities such as insurance system, Development Bank had a major impact on restricting the efficiency of the monetary policy operation of the State Bank.

From the above situation, in order to achieve the objectives of price stability and inflation control as top priority objectives, considering the current conditions of currency market in Vietnam, it is showed that there is still not enough vital conditions for the State Bank to completely switch into the monetary policy framework of interest rate regulation because of the following reasons: (i) the currency market performs ineffectively, there is a segment among the state-owned commercial bank group, big joint stock commercial bank group, foreign bank group and small joint stock commercial bank and financial company group, in which the small joint stock commercial banks with low credibility are allocated low loan limit by other Commercial Banks and the interest rate often are from 0.5-1%/year higher than the market rates, due to the lack of liquidity these banks sometimes push borrowing interest rate causing destabilization in the market; (ii) the competitiveness among banks is low, big commercial banks dominates the market; (iii) inflation is not stable and causes high pressures: inflation from 12.7% in 2007 was up to 22.3% in 2008; up to 11.8% in 2010 and inflation in 2011 rose to 18.3% in comparison with the same period in 2010; and (iv) the market psychology is easily affected by rumors and fluctuations of the domestic and international market of gold price and exchange rates.

\textsuperscript{29}Every year, the State Bank still has to supply a significant amount of money for the State Budget. Article 32 of the Law on the State Bank of Vietnam prescribed that "The State Bank shall provide advances for the central budget to deal with a temporary deficit in the state budget fund" but "these advance amounts must be refunded within the budgetary year". However, in fact these advances usually have no guarantee and are not been refunded within the budgetary year according to the regulation. Such loans without guarantee and refund lead to the increase of monetary base (MB), making M2 rise and resulting in a pressure of inflation increasing.
Independent status enhancement of the State Bank

Most of Central Banks in the countries which pursue inflation targeting monetary policy have the independent status in planning and carrying out monetary policy. This independent status have facilitated the Central Bank in proactively choosing and deciding policies, measures of monetary policy regulation, intervening the foreign exchange market without depending on other goals.

The above researches show that, if the State Bank of Vietnam wants to switch into the operating mechanism of inflation targeting monetary policy, first of all, institutions of monetary policy should be amended and adjusted by the National Assembly and the Government. However, to which direction this amendment and adjustment should be needs to be selected in accordance with political, economic and legal institutions in Vietnam.

At the present, the status of the State Bank is still ambiguous. Considering the current political institution, the State Bank is structured in the executive branch, functions as a sector-managing Ministry. The State Bank is an agency which is in charge of developing and regulating monetary policy. Article 1 of the Law on the State Bank in 1997 and Article 2 of the Law on the State Bank in 2010 stipulated: "The State Bank of Vietnam is a ministerial-level agency of the Government, the Central Bank of the Socialist Republic of Vietnam". In fact, the State Bank is commonly understood and treated as a ministerial-level agencies/ a state administrative agency, under the comprehensive management and administration of the Government about its organization as well as operation. According to the Law on the State Bank, there are up to 15 main contents which are directly or indirectly related to the monetary policy operation are determined by the Government or Prime Minister. On the other hand, obligations and

30It is necessary to emphasize that the State Bank, in terms of nature, first of all is a bank - the money-issuing bank, the bank of the Government, especially the bank of banks; the State Bank has legal personality, legal capital, balance sheet and the profitable professional activities; though the operating objective is not profit. Therefore, because the State Bank has the particular nature, it needs to have the competence to carry out the major objectives, functions, missions as a Central Bank, even though this agency still belongs to machinery of the Government.
responsibilities about the efficiency in running monetary policy of the State Bank have not been explicitly specified.

Considering the current economic institution, the State Bank depends, almost absolutely, on the Government in finance. The legal capital of the State Bank is defined by the Prime Minister and funded by the state budget. Financial revenues and expenditures of the State Bank are defined in a specific way by the Government; however, the principles of implementing them comply with the provisions of the Law on the State Budget.

It is difficult to give a perfect scenario for innovation of the State Bank ensuring it as the Central Bank that has the high level of independence in running monetary policy because the political and economic institutions of Vietnam are under the process of innovation, improvement in order to meet the requirements of international integration. Therefore, the research team focused on assuming one of two following scenarios.

**The first scenario: Innovation of the State Bank of Vietnam following a modern Central Bank model directly under the National Assembly.**

With this scenario, the Central Bank is ensured to have a legal position with high independence, one side, the Central Bank will not be under the pressure from the Government resulting in passively operating monetary policy, on the other hand, the Central Bank will have high responsibilities in accountability, publicity and transparency to the public about the results of its monetary policy operation.

There are two problems that need to be clarified in the first scenario, they are the under-National Assembly nature and the modern Central Bank model. First, the under-National Assembly nature: the Central Bank under National Assembly is not an agency under the National Assembly machinery. The bodies under the National Assembly machinery have the legislative function, and the Central Bank has its own functions. The under-National Assembly nature of Central Bank here includes: (i) Monetary Policy Council (monetary policy planning and implementing Council) is established and decided by the National Assembly, the Governor and Deputy Governor of the Central Bank are elected and decided by the National Assembly; (ii) the legal
capital and operational finance of the Central Bank are passed by the National Assembly, supervised by the Budget Committee of the National Assembly and the State Audit Office. Second, the modern Central Bank is a central bank which has operating objectives in accordance with its "natural functions" and has full competence as well as conditions in order to achieve these goals for the general benefit of the society.

It can be said that the level of independence in monetary policy operation in the first scenario seems to be absolute. The Central Bank has the discretion in operating monetary policy in order to achieve the planned objectives. One side, the Central Bank is completely not under any pressure from the Government; on the other hand, because the accountability requirement to the National Assembly (means to the public) is very high, the Central Bank will have a strong determination in running monetary policy with view to reaching their committed goals. However, this choice is certainly not appropriate in the medium term (5-10 years) for the Central Bank of Vietnam. One of the reasons is that the legal institutions require us to amend from the Constitution of the Socialist Republic of Vietnam to lots of basic laws such as: Law on Organization of the National Assembly, Law on the State Bank, Law on Credit Institutions, State Budget Law, Commercial Law, etc... This is a very difficult matter in the medium term.

The second scenario: Innovation of the State Bank following a modern Central Bank model\(^3\), being independent of the Government in the implementation of monetary policy.

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\(^3\)A modern Central Bank is construed as an institution: (i) Having clear operational objectives: To fully implement the functions, duties of a Central Bank in the market economy; not to carry out tasks which do not belong to the competences and responsibilities of a common central bank; (ii) Having a certain degree of independence/autonomy (accompanied with responsibility and public, transparency) to enforce its duties (in the major aspects such as: leader staff; operation according to functions; organizational apparatus-payroll; financial mechanism ...), especially the high level of independence in monetary policy operation; (iii) Having the structure organized in a streamline way, the operational mechanism which is valid, effective and capable of quickly responding to changes of the operational environment; strong and stable infrastructure; the skilful and intensively trained staff.
This scenario really means that the *Central Bank is relatively independent of the Government*. In terms of organizational model, the Central Bank is a part of the Government, under the management of the Government about the organizational structure. However, in terms of operating model, the Central Bank is independent in determining the volume of money supply to the economy and actively using tools in order to manage monetary policy in an effective way. Of course with this scenario, the Central Bank still depends on the Government in operational finance; therefore, it is still under some certain pressures from the Government. To restrict the pressures from the Government, the activities of monetary policy operation of the Central Bank have to be passed by the National Monetary Policy Council which is established according to the decision of the National Assembly. This enables the National Monetary Policy Council to be independent of the Government so that the monetary policy decisions will be more proactive and appropriate with the Council's objectives.

**National Monetary Policy Council** is established differently from the current National Monetary Policy Advisory Council in power structure, duties, Council components, individual responsibility as well as the relationships with the Central Bank. In particular, the National Monetary Policy Council is the supreme body having rights and taking responsibilities (by law): (1) planning and monitoring the implementation of national monetary policy according to objectives that were ratified by the competent State agency, as well as deciding other major issues relating to national monetary policy; (2) planning and monitoring the implementation of the Development Strategy of the credit institution system, as well as deciding other major issues relating to the bank regulation and supervision; (3) in addition, the National Monetary Policy Council has the following tasks and rights: (i) ratifying the organizational structure and competences, responsibilities of the units under the Central Bank, (ii) ratifying principles for all activities and transactions of the Central Bank; and (iii) ratifying the budget of Central Bank.

Head of the National Monetary Policy Council is the Chairman – the Governor of the State Bank. The Council operates as a governing body, works under the collective model, makes decisions by the majority of votes. Assisting the Council is the Secretariat - including some experts of the Central Bank (they can works under the concurrent or specialized and responsible model). The Chairman and members of the National Monetary Policy Council are elected and
approved by the National Assembly on the basis of the proposal of the Prime Minister. Regarding the organization, the National Monetary Policy Council is usually seen as a superstructure of the Central Bank. To ensure objectiveness in the monetary point of view, the activities of the National Monetary Policy Council is funded by independent financial resources.

The Executive Committee (the Governor and Deputy Governors): The Governor is a person who conducts and manages all activities of the State Bank, a person who makes the decision for professional issues to implement resolutions, decisions of the National Monetary Policy Council. Deputy Governors are the assistants of the Governor, assigned to manage some certain segments/operations as authorized by the Governor.

Thus, with this model, the Central Bank is reformed towards the direction in which it is only independent of the Government in managing monetary policy and can be reformed in the medium term because it is not necessary to amend many legal systems with the application of this scenario, the Government just needs to do some activities as the following:

- The Government suggests the National Assembly to pass the National Monetary Policy Council and appoint the Chairman of the National Monetary Policy Council.

- The Government gradually hands over the executive power of monetary policy to the National Monetary Policy Council in the medium term.

Currently, the role of the State Bank of Vietnam is still restricted. The current mechanism of monetary decisions is complex, and has not yet shown the role, the autonomy of the State Bank. In addition, not only the National Assembly and the Government, but also too many other state agencies get involved in conducting, supervising the construction and implementation of monetary policy. It can be said that the deep conduct of the Government reduces the independence, activeness of the State Bank in conducting monetary policy in a flexible way. According to the provisions of Law on the State Bank, the Government decides the additional amount of money supply for annual circulation. Therefore, every year, based on socio-economic indexes on economic growth rate of the Government, inflation rate and other macroeconomic indicators, the State Bank calculates and determines the additional amount of money supply and
submits it to the Government for approval. Every quarter, the State Bank calculates the additional amount of money supply for each purpose such as buying foreign currency, granting refinancing loans (including OMO, discounts, loans secured by the pledge of valuable papers, foreign currency swap, etc...) on the basis of approved scope.

However, in the context of the market with a lot of unpredictable changes, it is required that the operation of the State Bank needs to be more flexible, the restriction by predefining the amount of money supply yearly or quarterly (even though it can be also adjusted) have limited the activeness of the State Bank in regulating the market. This can cause fluctuations in the market interest rate, especially the interbank interest rate. For example, in case that the capital of commercial banks is largely deficient, and excesses the approval amount of money supply, if the State Bank does not pump enough money to meet the needs of the market due to the restriction of money supply quota, the market interest rate will sharply increase, destabilizing the currency market\(^{32}\).

Towards the application of inflation targeting monetary policy, the State Bank needs to have more independent position (relatively independent). The experience of some countries shows that the independence here is not necessarily independence of the organizational model, or independence in determining monetary policy objectives. It is a complete independence (both in legislation and in reality) in using monetary policy tools with view to obtaining inflation target.

**Establishment of the Executive Board of Monetary Policy directly under the State Bank**

International experience of policy operation shows that most countries have established the Executive Board (or Council/Committee) of Monetary Policy and this Executive Board plays a very important role in operating monetary policy. Meanwhile, Vietnam has The National Monetary Policy Advisory Council (as stipulated in Article 4 of the Law on the State Bank in 1997, the Governor is just a standing member of the Council). The Current National Monetary

\(^{32}\)Since 2012, the State Bank has been more active in determining the additional amount of money supply for annual circulation
Policy Advisory Council is still not an agency that has the full competence and responsibility in making important decisions in running monetary policy and in other activities of the State Bank.

According to the provisions of Paragraph 4, Article 7 of Law on the State Bank in 2010, the Governor of the State Bank shall decide on the establishment and termination of operation of branches, representative offices and consultancy committees and councils for matters related to the functions and tasks of the State Bank. Therefore, to ensure consistency in running monetary policy, enhance coordination among macroeconomic policies and clearly assign responsibilities, firstly, the State Bank should establish its Executive Board of Monetary Policy according to the following directions:

*Members of Executive Board of Monetary Policy*

The Chairman of the Council should be undertaken by the Governor, the standing member is the Deputy Governor who is assigned to be in charge of conducting the implementation of Open Market Operations (OMO)\(^{33}\), the other members are the Deputy Governors and heads of some relevant Departments of the State Bank, and the members of Executive Board of OMO are key members. In order to ensure the effectiveness of members' performance, Executive Board for Monetary Policy should clearly define rights and responsibilities for each member of the Executive Board.

*Mode of operation*

\(^{33}\)Currently, the State Bank has the Executive Board of Open Market Operation, in which Head of Executive Board is one Deputy Governor of the State Bank, other members are some leaders of relevant Departments of the State Bank. The Executive Board of OMO has roles in conducting not only OMO operations but also other banking operations. Once the Executive Board of Monetary Policy is established, the members in the current Executive Board of Open Market Operation will play a pivotal role in the Executive Board of Monetary Policy. The Executive Board of Monetary Policy will have the greater rights and responsibilities than that of OMO.
The Executive Board of Monetary Policy will meet and decide the operating plan of Monetary Policy in the coming month, including the objectives of monetary policy operation and the operating plan of all monetary policy tools which OMO is included in. Especially, in case that the State Bank made the regulation of the interest rate on the basis of having established the interest rate corridor and taken 7-day Repo rate as the oriented interest rate, the Executive Board of Monetary Policy determines the Repo interest rate in the coming month.

The meeting of the Executive Board should be informed in advance (it is preferably fixed monthly and should be organized after the point of time when the consumer price index was published). At the same time, some main orientations in operating monetary policy should be publicly announced and clearly explained so that the Credit Institutions as well as the public can know the operating orientation of the State Bank. This will contribute to create the market's expectation following the orientations of the State Bank as well as enhance the transparency of operating monetary policy.

**Operation of monetary policy following the interest rate corridor framework**

As mentioned in the previous section of selection of the operating objective of the State Bank, in order to achieve the objectives of currency value stability and inflation control as top priority objectives, considering the current conditions of currency market in Vietnam, it is showed that there is still not enough vital conditions for the State Bank to completely switch into the monetary policy framework of interest rate regulation. Therefore, the State Bank continues to choose operating objective following the volume in combination the regulation of interest rate, simultaneously prepares the conditions to gradually turn into regulating interest rate in order to improve efficiency and increase transparency in monetary policy operation, proceeds to implement inflation targeting monetary policy framework with view to reaching monetary policy objectives which are clearly stated in the Law on the State Bank in 2010. According to this, the State Bank continues to manage the amount of money supply within the scope approved by Prime Minister in order to obtain oriented currency indexes (total means of payment and credit) in combination with regulating interest rate to reach inflation target passed by the National Assembly.
Hence, while it is impossible to switch into inflation targeting mechanism, the State Bank has still studied to apply monetary policy according to interest rate; the first is establishing an interest rate corridor (highest and lowest) to regulate the market, such as the mechanism in the UK, Poland and Hungary, so as to affect inflation.

In the coming time, the State Bank should set the interest rate corridor wide enough to motivate the inter-bank market, in which interest rate applicable to overnight loan of the State Bank is interest rate ceiling, interest rate applicable to deposit of Credit Institutions at the State Bank is interest rate floor, particularly: (i) interest rate floor: is deposit interest rate which is formed on the basis of bidding or being fixed by the State Bank. In the context of lacking disposable capital now, the State Bank should fix this interest rate; (ii) interest rate ceiling: is interest rate applicable to overnight loan in inter-bank electronic payment and applicable to loan for making up capital deficit in the clearing payment of the State Bank for Credit Institutions (referred to as overnight lending rate of the State Bank for Credit Institutions), in which the overnight lending rate will be adjusted in accordance with other interest rates in the inter-bank market.

The overnight lending rate of the State Bank is selected as the interest rate ceiling due to the reasons: (i) nowadays the inter-bank electronic payment system is more and more developing and functions as the backbone payment system of nation; therefore, Credit Institutions make inter-bank transactions primarily through the inter-bank electronic payment system; (ii) the Credit Institutions satisfying enough conditions can be provided overnight loan by the State Bank (at the end of working day, if the Credit Institutions have temporary shortages of liquidity and pledged assets under the provisions of the State Bank, Credit Institutions can be provided overnight loan by the State Bank), and (iii) the overnight lending rate of State Bank for Credit Institutions is now the highest interest rate of State Bank.

The market-oriented interest rate is the 7-day bid interest rate in OMO in this "corridor" to send clear signal to the market. The reason for choosing 7-day bid interest rate as the market-oriented interest rate is that it is the period which is mainly applied in OMO by the State Bank, hence changes in this interest rate will have a significant impact on loans of the State Bank for Credit
Institutions, which will affect other interest rates in the currency market, especially the overnight lending rate in the inter-bank currency market.

At the same time, after participating in OMO, in case that Credit Institutions which still lack of capital but do not borrow from the other Credit Institutions can borrow from the State Bank at interest rate equal to overnight lending rate (interest rate ceiling); or if Credit Institutions which still have a redundant capital and do not lend this amount in the inter-bank market can make a deposit at the State Bank at interest rate equal to deposit rate (interest rate floor). This interest rate managing mechanism will create incentives for Credit Institutions to borrow from each other in the inter-bank currency market, if not they will borrow from the State Bank at interest rate ceiling (in case of lack of capital) or only receive interest rate floor (in case of excessive capital).

In the first stage of implementation, the interest rate corridor may be wider, and then be narrowed.

The coordination mechanism of macroeconomic policies

To achieve the planned macro-economic targets, monetary policy is difficult to be successfully implemented without having good coordination with other macro-economic policies, especially fiscal policy. Moreover, in Vietnam, the National Assembly sets goals such as growth, inflation but we have not officially taken measures, general coordination mechanism to obtain these goals. The forecast of inflation and growth target is often based on figures achieved in the previous year and does not include fluctuation forecasts during the plan period as well as the impact lag of policies in the previous period. Furthermore, fixing target at a specific number without defining frame of variation in unpredictable conditions will cause a lack of trust in policy commitments. Because it is impossible to pursue two opposite objectives simultaneously, it is necessary to regularly and consistently identify and announce the objective which needs to be focused on in each period in order to have operation orientation to each policy. On that basis, the operations of each policy should be coordinated in order to achieve goals in each period, without detriment to the long-term goals.
In fact, in some periods, the Government called for price stability in order to maintain the inflation target, but the government’s debt did not reduce, budget deficit was high, outstanding loan of development fund system (Development Bank) continuously increased and salary adjustment periods were very sensitive. This was really a kick pushing the price level. The reason of inflation increase resulting from M2 growth were also that deposit of the State Treasury at Commercial Banks was still high, budget investment and development credit through the National Development Bank were also high but deposit of the State Treasury was not flexibly transferred to the State Bank in order to limit money multiplier. The spread and impact of this situation were that interest rate level was pushed and the needs of Credit Institutions for raising capital sharply increased (especially at the end of the year) due to the pressure of growth rate set by the National Assembly. The high interest rate and tightening regulations in controlling credit quality of banking system would cause a relative decrease in investment demand, while high interest rate could not reduce inflation rate because the main reason is from the aggregate supply: world raw material price, structural issue, effectiveness, etc...

In the first months of 2011, along with giving a strong message and synchronized solutions to curb inflation, enhance macro-economic stability, ensure major balances of the economy, the Government emphasized the importance of close coordination of macroeconomic policies, especially coordination between monetary policy and fiscal policy in the "war" against inflation. According to this, the Government determined that inflation controlling was the number one solution among solutions to macroeconomic stability, it was needed to run monetary policy in an active, flexible and cautious manner, tight fiscal policy, coordinate monetary policy in harmony with fiscal policy in order to control the speed of Total means of payment, credit, make sure of interest rate at a reasonable level, and ensure liquidity for the economy. However, the important thing is that policies need to be implemented synchronously, effectively to achieve goals and bring belief to investors and the public.

**Effective coordination between monetary and exchange rate policy, towards a more flexible regime of exchange rate**
According to the theory of "impossible trinity" (Trilemma), it is impossible for a country to reach all three of the following objectives at the same time: (i) free capital movement (absence of capital controls), (ii) an independent monetary policy, and (iii) a fixed exchange rate (the exchange rate is fixed or has adjustable anchors). Meanwhile, Vietnam has opened the capital account according to committed roadmap: (i) foreign exchange policy was gradually liberalized, a lot of licenses were deleted in order to match with international practices and integration requirements; (ii) the operating mechanism of exchange rate was changed from fixed exchange rate to adjusted exchange rate, and to the announced exchange rate equal to the rate which was defined at the end of the day in the market; (iii) since December 2005, current transactions has fully been liberalized and capital transactions has considerably been loosened with the promulgation of the Ordinance on Foreign Exchange.

Therefore, one of the top priority objectives of our State is now attracting capital from foreign countries to support economic development. This also means that Vietnam should choose one of two remaining objectives of "impossible trinity" - keeping exchange rate relatively independent or autonomy in monetary policy in order to find the development path that can be match with the specific condition, circumstance of the economy. This is the conundrum for monetary management authority of the countries in general and Vietnam in particular. Therefore, to ensure the common goal, the effective coordination between the regulation of foreign exchange rate and monetary policy tools should be especially valued.

However, in practice, the operating objective of exchange rate policy is still unclear. That the goal of exchange rate operation is currency value stability, implying internal stability (inflation is curbed) and external stability (exchange rate is stable) still contains conflict: (i) First, Law on the State Bank stipulated that if the exchange rate is a tool of monetary policy, it can not be an objective of policy, if the target is to stabilize currency value it is difficult to conduct monetary policy in the context of fast and strong foreign capital inflow during liberalization process; (ii) Second, in the context that changes in the foreign exchange market are complicated, unpredictable, the economy has a high level of openness, capital transactions has gradually been liberalized, the policy announcements of the Government on amplitude fixing or an increase/decrease of exchange rate will encourage speculation and in case that the world market changes
too complicated, the Government can not maintain policies as previously announced and as a result, it will somewhat affect the belief of the market

With the current multi-objective monetary policy, the activity of monetary policy operation sometimes conflicts with some measures of exchange rate stability. For example, during the period between the end of 2008 and the beginning of 2009, while Vietnam Dong was under devaluation pressure, monetary policy was loosened to ensure economic growth target which had previously been set by the Government. This made measures of exchange rate stability (foreign exchange intervention, exchange rate adjustment towards export supporting, etc...) not be carried out in an effective way.

Thus, it shows both in theory and in reality that a good coordination between monetary policy and exchange rate policy is an essential requirement. The relatively flexible adjustment of exchange rate should be based on the relatively tight management of monetary policy. In the coming time, monetary policy and exchange rate policy should be effectively coordinated to ensure objectives of inflation control, trade deficit restriction as well as attractiveness reduction of foreign currency speculation.

International experience in giving and applying inflation targeting monetary policy shows that efforts improving implementation capacity of a flexible exchange rate mechanism (developing the efficiency of foreign exchange market, setting an appropriate risk management system of foreign exchange, forming a consistent intervention policies, etc...) promoted the ability of countries in applying inflation targeting as a new monetary policy framework. Therefore, establishing the ability to implement inflation targeting and switching into a flexible exchange rate mechanism are enhanced at the same time. Therefore, to pave the way to apply inflation targeting in Vietnam, an especially important issue is to improve the implementation capacity of a flexible exchange rate mechanism.

In the context of current economy, the operation of exchange rate policy needs to be carefully considered based on calculating and grasping the trend of real effective exchange rate (REER)\textsuperscript{34},

\textsuperscript{34}Since 2003, the State Bank has began calculating REER index and took it as a basis for reference in operating daily exchange rate to gradually separate the depreciation of VND on USD and step by step
in order to have adjustments in accordance with central operating rate or fluctuation amplitude of exchange rate. Moreover, the operation of exchange rate mechanism needs to be flexible, also cautious, often follows the fluctuation of USD in the world market and relies on the supply and demand relation of foreign currency in domestic market in order to avoid risk shocks when the economic environment changes rapidly. The fluctuation amplitude of exchange rate needs to be usually announced in both directions, it means that exchange rate can increase and also decrease in the short term. This announcement will restrict psychology of waiting the regular rise of USD comparing with VND. The intervention activities of the State Bank can not be principal tools to control exchange rate, just have some certain impacts and then are eliminated through the reverse transactions. The long term development direction is to gradually diminish the regulation of the State by often opening both directions of amplitude and considerably increasing amplitude until there are enough macroeconomic conditions (having high and sustainable economic growth; building and managing strong foreign exchange reserves, ensure security, liquidity and profitability; building a banking system which is strong enough and can participate in the international foreign exchange market; developing payments via bank; developing the domestic financial market and currency market effectively; implementing capital mobilization policy in domestic and in abroad, having a sufficient and integrated legal corridor to create and maintain a healthy business environment) so that exchange rate can be floated.

**Accountability mechanism and transparency**

An important reason for implementing inflation targeting monetary policy is that it makes monetary policy become clear and transparent. There are two issues that need to be researched for use. First, how is inflation target transferred to the public and to the market? Second, what will the responsibility of the State Bank in implementing inflation target be?

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attach VND with a "currency basket" containing the country currencies of main commercial partners. Every day, the State Bank updates the fluctuations of nominal exchange rates of the currencies in the basket to put into the model of defining this real effective exchange rate, including inflation adjusting variables and trade weights. REER index was used as a reference for the State Bank to impact the exchange rate in the interbank foreign exchange market with view to orienting exchange rate following the target level, ensuring the ability of foreign affairs and limiting negative impacts of the consumer price index changes.
One of necessary requirements for the successful implementation of inflation target is to establish specific mechanisms of transparency and accountability of the State Bank to the public. This requires a selection of a suitable transmission mechanism, including: transmission content, transmission manner, and the commitments when content transmission is published.

First, transmission content should include: (i) the attitude of the State Bank to the implementation of the inflation target; (ii) overview of inflation situation on target; (iii) inflation changes in fact; (iv) actions/solutions of the State Bank to implement inflation target; and (v) the explanations when the target needs to be adjusted.

Second, transmission manner that can be applied are regular, periodic and non-periodic channels. Regular channel, periodic channel (monthly, quarterly) are through publications such as annual reports, periodic reports on inflation; through the regular explanation of the Governor of the State Bank on television. Non-periodic channel is through press conferences, press and public responses.

Third, commitment to transmission content: publications - reports, press responses of the State Bank should be authenticated by the Governor of the State Bank.

To ensure responsibility of the State Bank in the implementation of inflation target, in addition to the transparent transmission of information to the public, the Governor of the State Bank needs to clearly demonstrate commitments to the higher authorities, such as: (i) letters or written commitments with the National Assembly; (ii) letters or written commitments with the Prime Minister; (iii) letters or written commitments with the President.

On the basis of the fact of the State Bank, compared with international experience, enhancing communication in operating monetary policy needs to be strengthened more in the following aspects: In the short term: (i) the State Bank identifies the type of information that needs to be disclosed to the market, (ii) prescribes information of operating monetary policy that needs to be published regularly (or irregularly); (iii) conducts regular or irregular surveys to poll the opinions of currency market members on information demand, information providing channels; and (iv) in the website of the State Bank, information of monetary policy operation is provided sufficiently,
ensured transparency so that all currency market members can be able to access and update information in time.

In the medium and long term: (i) holding periodic or irregular press conferences when there is any change in monetary policy operation; (ii) periodically publishing reports of the State Bank on monetary policy operation, analysis and forecast of outlook for macro-economics, inflation, currency finance and operation orientation.

**Technical processing issues**

*Method of calculating and measuring inflation* 35

In fact, most countries often use consumer price index (CPI) as a platform tool when calculating inflation, because of its own advantages such as: it is relatively known by the society, is published and calculated regularly. In addition, the State Bank can use CPI excluding some factors (factors are in the short term and quickly disappear) - this adjusted index is called core inflation index

It can be said that CPI calculation to measure inflation in Vietnam has a lot of shortcomings. Evaluating inflation targeting monetary policy in Vietnam only based on CPI is unreliable. In particular, the statistics defining consumption structure proportion to determine CPI weights is not updated with the consumption trends in the society. For example, calculating CPI in 2010 was still based on the survey results in 2005. This is the technical reason causing deviation of CPI, the method of surveys and statistics was so primitive that CPI was inaccurate. Therefore, the general recommendation for this research is: (i) improving the quality of statistics, including price and currency statistics; (ii) General Statistics Office (GSO) needs to study and convert data chain into a comparison base in order to ensure consistency of the data; GSO collects information, designs information collection form and send it to Ministries and Agencies in order to provide data periodically, through which fixed weights are specified again to suit the social

35See Appendix for Method of calculating and measuring inflation
trend towards proportion reduction of food group (currently accounting for 39.93% in CPI); (iii) General Statistics Office needs to be accurate and prompt in surveying and collecting data, eliminate all impacts causing statistical deviation. To do this, it is necessary to improve statistic apparatus from the central to the local level, create a reliable basis to follow, update price fluctuation, and rapidly provide information in time

*Forecast of inflation*

Inflation forecast is a special challenge for most countries. Inflation forecast plays an important role in conducting policies when a country implements inflation targeting, because there is always a lag between the operation of monetary policy and these impacts on inflation index. Inflation forecast can be considered as the intermediate target of policy. The emerging economies depend less on market statistics to forecast inflation due to lack of data, continuous structural changes, and vulnerability of these markets to shocks. Surveys on inflation expectations which are carried out by the private sector or even the State Bank are quite useful in inflation target mechanism. In fact, inflation forecast bases on the combination of many variable indicators, econometric model and quality assessment.

In Vietnam, forecast of the economy in general, the capacity of analyzing and forecasting inflation in particular are still restricted due to lack of database to establish an inflation forecasting model and lack of qualified staff to set up a practical model. Also, the State Bank does not have an information system to timely update changes in the financial market and the economic situation affecting inflation in order to have the basis of analyzing and forecasting inflation in an accurate way.
CHAPTER 6
IMPLEMENTATION ROADMAP OF INFLATION TARGETING MECHANISM IN VIETNAM

SELECT AND DEAL WITH TECHNICAL STRUCTURE

Technical structure of inflation targeting monetary policy typically includes: date of implementation, consumer price index and frame of consumer price index frame, implementation instrument and transmission channel.

Time of application

The experience in many countries shows that the implementation of inflation targeting monetary policy in these countries may originate from a shock/crisis, but most of them derived from expectations of a new monetary policy framework more effective by the Central Bank. However, one thing in common of these countries is they adopt full-fledged inflation targeting is at the point when the economy inflation is low or under controlled and the relevant institutions allow the Central Bank adopt inflation targeting monetary policy effectively.

Nowadays, Vietnam cannot meet these two requirements because: (i) since 2004, inflation in Vietnam changes complicated, now the Central Bank cannot control inflation in the short term, (ii) in the short term, the Central Bank cannot reform quickly to meet the basic requirements in order to adopt the inflation targeting monetary policy. Therefore, Vietnam cannot immediately change to full-fledged inflation targeting mechanism.

However, Vietnam can adopt implicit IT at the beginning (the Central Bank may can agree with the Government on the implementation of inflation targeting without publishing for the general public). In the present condition, Vietnam can completely adopt the implicit inflation target immediately in 2013.
Inflation targeting framework

Inflation targeting framework is the band at which consumer price index is permitted fluctuating. The introduction of the consumer price index framework allow the Central Bank to respond to shocks flexibility and make optimal choices in the context of the Central Bank still pursue other goals. Furthermore, the band of the consumer price index frame foreshadows to the Central Bank the scope of the consumer price index fluctuations. The flexibility of the Central Bank depends on the band of the consumer price index frame. However, if consumer price index frame is too wide, it will make inflation expectations and the commitment of the Central Bank unclear. The option to narrow or expand the band of inflation frame depends on the frequency, the severity of economic shocks and credibility of the Central Bank. In order to provide a clear guidance regarding inflation expectations and overcome the disadvantages of a range of the inflation targeting index, most of the country’s Central Bank either just set the target point or both set the target point and allow fluctuation to be ± 2 % or less.

In countries implementing inflation targeting monetary policy, some countries adopt inflation targeting framework (New Zealand: 0-3 %; Canada: 1-3 %, EU: 2 % or < 2 %), while a number of other countries choose inflation targeting being a specific figure. For example, the UK and Poland specify monthly inflation rate in a year (compared with the same month the previous year) which does not exceed the target above. Meanwhile, Hungary takes consumer price index in December to compare with the index at the beginning of the year in order to compare with the target set for the year. Of course, comparing to these countries, the countries setting inflation targeting frame in a certain band have the obvious advantage point which creates greater flexibility. Besides, it conveys the message to the public that controlling inflation is a hard work to achieve absolutely result. Inflation targeting framework fluctuates in a range of certain band which facilitates the Central Banks in the commitment to the public that they will try to control inflation within that frame.

How the Central Bank of select a suitable inflation targeting framework?
Until now, the annual inflation target (31/12 in the year later in comparison with 31/12 in the year ago) by the National Assembly is seen as a permitted ceiling for inflation of that year. In continuous years, the real CPI often leaves at the point of large gap in comparison with the ceiling which the National Assembly allows. Because we determine the CPI lacking scientific evidence, from 2004 up to now, real inflation is often higher than inflation targeting (in 2007: the real inflation is 12.6%, the inflation targeting is under 8%; in 2008: the real inflation is 19.9%, the inflation targeting is under 10%, in 2010 real inflation is 11.8%, the inflation targeting is 8%). In some previous years, while the inflation targeting is high, the real inflation is very low (in 1999: the inflation targeting is under 10% but the real inflation is only 0.1%; in 2000: the inflation targeting is 6% but the real inflation is -0.6%). Establishing the inflation target has the ceiling but no the floor makes the Central Bank are passive in controlling deflation as well as administrate the monetary policy in general. From these studies, the research team proposes scenario of selecting inflation targeting framework which can helps the State Bank of Vietnam research applications when implementing inflation targeting monetary policy as follows:

Inflation targeting framework is band which both ensures price stability, control inflation and ensure minimal economic growth target. The band which can be rational for 5-year period implementing inflation targeting monetary policy is (6% / year, ±2% / year) and for the period of the next year is (4%/ year, ±1%). The basis of this scenario is explained as follows:

First, in the medium term, Vietnam is still the country with high proportion of imported raw materials. On the one hand, we depend on world prices, on the other hand, the mechanism of speculation control on distribution channel of imported raw materials are less effective. As a result, market price tendency still rises sharply and fluctuates annually. We cannot set inflation targeting band being narrower than ±2% for the first 5-year period and ±1% for the next years because actual inflation changes to divert the set band. If this happens, it will force the Central Bank have to explain and adjust the target which is very complicated.

Secondly, the error in calculating CPI may occur, especially when qualification and instruments in calculating CPI of Vietnam is limited. Therefore, the set band is ±2% for the first 5-year period and ±1% for the next stage is appropriate.
Third, the inflation rate floor being 4% for the first 5-year period and 3% for the next stage implies ensuring the economic reaches the minimum growth expectations.

Fourth, the inflation rate ceiling being of 8% for the first 5-year period and 5% for the next 5-year period also implies ensuring the control of lower inflation in the medium term but still stimulating economic growth expectations.

**Instruments of inflation targeting transmission**

The experience shows that all countries implementing inflation targeting monetary policy operate policy through dominant rate instrument of the Central Banks to impact on market interest rates.

The interest rate instrument of the Central Bank, on the one hand, maintains the stability of market interest rates; on the other hand, it facilitates the commercial bank manage liquidity. This instrument set a framework including the highest interest rate (the ceiling) and the lowest interest rate (the floor) that the Central Bank will apply for the commercial banks so that deposit rate, interest rate lending overnight in the interbank market and the primary interest rates of the Central Banks is in this framework. At the same time, this instrument also facilitates the commercial banks to deposit or borrow money from the Central Banks.

The concept of primary interest rate using in the administration of inflation targeting monetary policy also differ among countries. For example, in Poland, the primary interest rate is the rate the Central Bank applies in the open market. In the UK, the primary interest rate is the rate the Bank of England lends the commercial banks in a form of the repurchase agreement (Repo) within 2 weeks.

Based on the experience of many countries, the State Bank of Vietnam also has to choose an interest rate instrument as the primary one. This interest rate instrument must meet the following principles: (i) the primary interest rates implements the market-oriented role and it is a basis forming market interest rates, (ii) the primary interest rates ensures that the Central Bank is really the last lender of the commercial banks. It implies that the minimum interest rate the commercial
banks borrow the Central Bank must be equal or higher than interest rates on interbank market, (iii) the primary interest is determined on the basis of inflation expectations assessment in the minimum annual period because the transmission mechanism from primary interest rates to the inflation target has a certain time delay which usually takes about 1.5 - 2 years

ROADMAP FOR INFLATION TARGETING MONETARY POLICY IMPLEMENTATION

The analysis of the preconditions for inflation targeting monetary policy above implies that we need to determine the time for appropriate implementation in order to react to market volatilities without causing the shocks to the economy. Moreover, the Central Bank has to have a certain amount of time, on one hand, to CPI close to the selected target frame, on the other hand, have to prepare the prerequisites for the transition to the implementation of full-fledged inflation targeting monetary policy. On the basis of the analysis of previous content about inflation targeting framework, it can determine this preparation schedule in about 4-5 years (2012-2016). This is explained as follows:

When implementing inflation targeting monetary policy, we confirmed that monetary policy will pursue low inflation target to stabilize the price. Of course, this is the medium-term target has a delay at least 5 years. This implies a roadmap for the adoption of the policy is divided at least into two periods:

• The first 3-year period accepts inflation target being higher inflation with greater band (6 %, ±2 %).

• The period of 2 next year makes inflation frame down at a certain level (4 %, ±1 %).
In order that the State Bank may adopt inflation targeting monetary policy towards the schedule above, it is necessary to coordinate the groups of solutions:

- Groups of institutional innovation solutions: Setting the law of the State bank of Vietnam replaced the law of State bank towards reforming of the State Banks into to the modern Central Bank; establishing of the Monetary Policy Council.

- Group of technical solutions: Completing determination methods of CPI.

- Group of supporting solutions : promoting communication about inflation targeting, raising the capacity of forecasting inflation; developing and improving financial market; strengthening and developing banking system, improving transparency and accountability of the Central Banks; coordinating better between monetary policy and fiscal policy; completing the administration mechanism of exchange rate flexibility.

**CONCLUSION**

In the modern economies, although there are different opinions, the majority state that price stability, the control of low and stable inflation is the ultimate objective of monetary policy. To accomplish the ultimate goal, the history of the world economy and the fact of many countries point out that most of the Central Banks have used intermediate indicators such as the total amount of money (M2, M3), exchange rate or inflation target, as some "anchors " forcing monetary policy towards the ultimate goal. In particular, up to now, only about 30 countries around the world have used inflation targeting anchor but they proved quite effectively. The reached inflation rate is in the target frame or can be lower than it in all countries pursuing this policy. The countries implementing the inflation targeting monetary policy framework operate macroeconomic better than before the implement of it. At the same time, the ability to cope with the crisis of these countries implementing inflation targeting monetary policy is more appreciated than the others which do not apply.
Researching the experience in many countries implementing inflation targeting monetary policy shows that in order to apply this policy success, these countries have met a certain number of conditions. For examples: inflation target is the priority of the monetary policy’s objectives; there is no fiscal dominance and the Central Bank completes actively in the use of monetary policy instruments. The majority of the conditions and other factors being considered the bases for the inflation targeting framework can be establish after the adoption of inflation targeting.

Vietnam’s economy is integrating deeply into world economy; therefore, the State Bank of Vietnam needs to improve stronger towards the tendency of becoming the modern Central Bank in order to meet the requirements of Vietnam's economy. Meanwhile, with the increase in volatility of the world economy and the diversity of market economy development, the economic and currency transactions become more complex; thus, the management of monetary policy of the State Bank still has a few weaknesses. The mechanisms of monetary policy administration today do not appear effective in controlling inflation. From 2004 to now, the changes of inflation are complicated and increasing whereas macroeconomic faces with many instabilities.

The economy must have a solid foundation in the macroeconomic dimension as good as the support of the public and political institutions so that the administration of monetary policy achieves high efficiency. However, in Vietnam, the financial, fiscal and monetary institutions are so really powerful. It is expressed through the reality of the banking system, the fiscal policy as well as the independence of the State Bank. Thus, it is essential for Vietnam to continue to reform these institutions. This is also important condition which helps Vietnam change to mechanism of inflation targeting in the future. Besides, we also need the policies and measures to further strengthen the support and confidence of political institutions and the public in the State Bank. It can be done through the improvement of transparency and accountability of the State Bank. First of all, it is necessary to promote the exchange with the public, authorities and departments about the monetary policy movements of the State Bank so that the market believes in what the State Bank does, as well as effectiveness of the policies by the State Bank implements. Considering the prerequisites to adopt successfully inflation targeting in many countries shows that the transition to adopt full-fledged inflation targeting mechanism in Vietnam at the moment is not suitable because of many reasons as follows: (i) The State Bank
does not have full independence in the management and administration mechanism and is not completely active in the use of monetary policy instruments, (ii) price stability was considered initially the primary target of monetary policy by the State Bank Law in 2010. And in fact administrating the macroeconomic in 2010 and 2011, the target of controlling inflation has been considered more important but the monetary policy still was pulled between the goals of growth and inflation, (iii) financial markets and the banking system in underdeveloped countries are not really stable, (iv) controlling the short-term interest rates is not effective, (v) the calculation and measurement of CPI is not complete, (vi) the information system, database and the forecast of inflation are still limited, (vii) the transmission mechanism of monetary policy is not clear, and (viii) the coordination among macroeconomic policies, especially between monetary policy and fiscal policy is not good, tight, rhythmic and so on.

At the same time, the experience in many countries also points out that it would be a mistake if the successful implementation of inflation targeting (IT) required setting all conditions before the IT framework was put in place. This experience also shows that, nowadays, in many countries implementing successfully IT framework, a number of conditions are not right from the start, however, the authorities have established these conditions over time, and also applied "learning by doing" method. The State Bank will try its best to establish the necessary conditions and to work with the Government to lead to the target. Therefore, Vietnam can start to adopt the mechanisms of implicit inflation targeting and prepare the necessary premises in the transitions.

Applying in Vietnam, it is necessary to implement completely the mechanism of full-fledged inflation targeting monetary policy which can and should be the strategic view of monetary policy in the next 5 years. However, Vietnam still has many things to do until implementing completely inflation targeting framework. However, it not the reasons for which people have a pessimistic view of the ability to adopt the administration framework of the monetary policy which takes inflation as a target. First of all, we have to develop schedule for institution reform and prepare the premises for the adoption of this administration framework (It is able to adopt implicit inflation targeting of partial inflation targeting at the beginning) without waiting to meet the all conditions to implement. The experience in some countries (such as Chile, Israel, Hungary and etc ...) implementing the mechanism of inflation targeting monetary policy points
out that it is possible to implement this mechanism according to the approach of step-by-step progress in the transition period. Therefore, on the basis of studying about the experience in some countries implementing inflation targeting and the reality in the administration of monetary policy in Vietnam, the research has gained some achievements as follows:

• Evaluate the effectiveness of administration mechanism of monetary policy in Vietnam's 2000-2010 period (result, limitation) and offer some policy suggestions to improve the mechanism of current monetary policy and establish the premise for the adoption of inflation targeting in Vietnam. For example, determine the administration target of monetary policy, establishing the monetary policy council; administrate the monetary policy towards the framework of interest rate corridor; enhance the coordination between monetary policy and fiscal policy, reform the mechanism of exchange rate towards more flexible way and etc.

• Evaluate the ability to adopt inflation targeting monetary policy of Vietnam and proposing the establishment of premises to prepare the adoption inflation targeting monetary policy in Vietnam.

• Proposing the administration mechanism of inflation targeting monetary policy applied to Vietnam on the basis of giving innovation scenarios for the State Bank of Vietnam towards the modern Central Bank; selecting techniques structure of inflation targeting monetary policy including: date of adoption, CPI and CPI framework, implementation instruments and transmission channels, transparency and accountability.

• Proposing an adoption schedule of inflation targeting monetary policy in Vietnam

• Proposing some groups of solution to adopt successfully inflation targeting monetary policy in Vietnam.
APPENDIX

GENERAL CALCULATION OF INFLATION IN VIETNAM

In Vietnam, General Statistics Office (GSO) is the agency which is responsible for calculation and official publication of inflation target and the indexes representing the inflation in Vietnam. They is various in different periods of time as following:

• From 1998 onwards: RPI (Retail Price Index).

• From 1998 to now: this index is replaced with CPI (Consumer Price Index).

• Besides, in 2002, PPI (Producer Price Index) was also calculated by General Statistics Office but up to now, it has not been published officially.

The formula for calculating the price index representing inflation of Vietnam: From the years of the ‘80s and before, General Statistics Office applied Paaschee formula to calculate RPI as follows:

\[ p_p = \frac{\sum p_i t \cdot q_{i t}}{\sum p_{i 0} \cdot q_{i 0}} = \sum D_t \cdot \frac{p_i t}{p_{i 0}} \]

Among them:

qit : is the quantity consumed of item i at time t

pio: is the price of item i at time 0

Pit: is the price of item i at time t

Pp: is GDP deflator

Dt: “fixed-weighted” index in the current year = \( \frac{\sum p_i t \cdot q_{i t}}{\sum p_{i 0} \cdot q_{i 0}} \)

o Meaning: how much money being spending at the base period (0) to purchase a number of goods and services at the current time (t).
o Pros: the basket of consumer goods continues to be updated with the changes in human needs over time.

o Cons: “fixed-weighted” index changes annually (the amount of the current year t) so the investment in each year is very expensive.

It underestimates the increase in cost of living due to not reflect the loss of consumer welfare when the prices increase.

Therefore General Statistics Office turned to apply Laspey formula.

From the 1990s to now, GSO applies Laspey formula, as follows:

\[
P_L = \frac{\sum P_{it} \cdot q_{io}}{\sum P_{io} \cdot q_{io}} = \sum D_{io} \cdot \frac{P_{it}}{P_{io}}
\]

Among them:

qit: is the quantity consumed of item i at time t

pio: is the price of item i at time 0 (the base period)

Pit: is the price of item i at time t

PL: inflation index (CPI)

Dto: fixed index of the current year =

o Meaning: how much money being spending to the current time (t) to purchase a number of goods and services at the base period (0).

o Pros: Because of fixed index (of the base year 0), costly expense is reduced 5 years the new GSO survey.

o Cons: It overestimates the increase in cost of living without calculating the use of alternative consumer goods when the prices rise.
Some criteria of inflation: CPI rate is published monthly, annually towards four criteria: (i) comparing with the base period, (ii) comparing with the same period, (iii) comparing with the beginning of year, and (iv) comparing with the previous month.
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INFLATION TARGETING AND THE IMPLICATIONS FOR MONETARY POLICY FRAMEWORK IN VIETNAM

Published by:
HAO CHU

Edited by:
BICH THUY NGUYEN

Printing edited by:
NAM HOANG

Book cover painted by:
THAI DUNG

ISBN: 978-604-908-613-7