SOLUTIONS TOWARDS A STABLE MACROECONOMY IN VIETNAM

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Abstract

Macroeconomic instability index showed that Vietnam has actually fallen into the state of macroeconomic instability Such instability resulted from external causes (net capital inflow and the global economic crisis) and internal causes (Vietnam's loose monetary policy led to a bubble growth in real estates and securities markets, and the expansive fiscal policy led to an increase in inflation, interest rates and foreign debt. It also reflected side effects of inappropriate policies which were applied to deal with external "shocks". This paper attempted to explain causes of Vietnam's macroeconomic instability and proposed needed solutions.

1. Introduction

Macroeconomic instability is always associated with negative changes in important macroeconomic variables such as inflation, budget deficit, exchange rates, and foreign currency reserves. This paper utilized macro-economic instability index (MII) of Ismihan and authors (2002) and macro-economic instability index (mi) of Jaramilo and Sancak (2007) to assess current instability in Vietnam.

Macroeconomic instability can result from both external shocks and inappropriate internal economic policies. External shocks are changes in ratio of foreign trade to GDP (Svensson and Razin, 1983), capital inflow (Takagi and Esaka, 2001), and global economic crisis (Clipa and Caraganciu, 2009). Policy causes include government's budget deficit (Gupta, 1992), excessive public investment (Fischer and authors, 2002) and over-expanded monetary policy (Pradhan and authors, 2011). All causes are presented in Graph 1.

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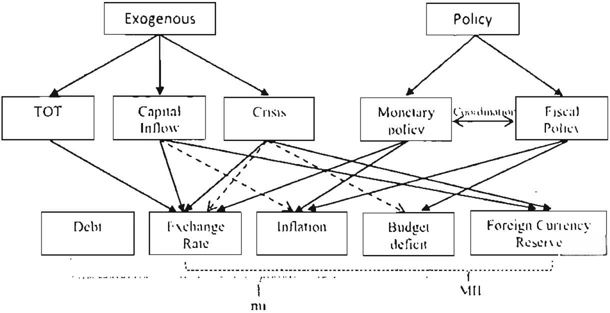
2. Status of Vietnam Macroeconomic Instability

Assessment of Vietnam's Macro-economic Instability used MII and mi

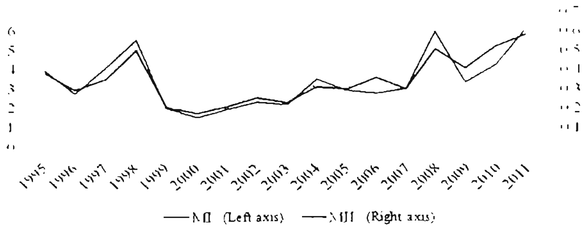
In term of trend, both MII and mi provided a quite similar result in assessment of Vietnam's macroeconomic instability. Quantitatively, MII and mi growth rates reached their peaks in 2011, 2008 and 1998 when the economy was hit by global and regional economic crises. An increasing growth of these two indices during 2008 – 2011 reflected a higher level of macroeconomic instability in Vietnam.

Graph 1: Causes of Macroeconomic Instability



Sources: Summarized by the authors.

Graph 2. MII and mi of Vietnam during 1995 – 2011



Source: Cunculated by the authors based on ADB and IFS data.

In term of percentile of component sub-indices, economic instability during the period of 1995 1998 mostly resulted from changes in exchange rate, that of 2001 – 2007 - from inflation and budget deficit; and that of 2008 – 2011 – from budget deficit (according to MII) and inflation (according to mi) (See Table 1)

Percentile of the component sub-indices presented contribution of each variable to MII and mi in each time period, however, both indices came up with the same conclusion that budget deficit and inflation were the two variables that influenced macro-economic instability the most.

Table 1. Proportion of component sub-indices of MII and mi, by time period *(Unit %)*

MII	1995 - 1998	1999 - 2000	2001 - 2007	2008 - 2011
Budget deficit	30.5	63.7	36.5	37.0
Inflation	24.9	13.2	44.0	23.5
Exchange rates	42.4	21.8	19.1	18.9
Foreign debt	2.1	1.3	0.4	20.6
Total	100.0	100.0	100.0	100.0
Mi	**1995 - 1998**	**1999 - 2000**	**2001 - 2007**	**2008 - 2011**
Budget deficit	35.5	56.4	53.5	22.1
Changes in inflation	19.6	7.8	27.4	40.5
Changes in exchange rates	41.6	29.6	15.6	34.9
Foreign currency reserve	3.4	6.1	3.5	2.6
Total	100.0	100.0	100.0	100.0

Source. the authors.

Causes of Vietnam's Macroeconomic Instability

Monetary Policy and Its Impacts to Inflation

Expansive monetary policy was implemented continuously from 2003 to 2007. Money supply and credits were increasingly issued and reached the peaks in 2007; meanwhile, interest rates were stabilized at less than 8.25% (Graph 3 and Table 2)

The expansive monetary policy encouraged production, consumption and economic growth. However, an abundant credit supply also increased speculation in stocks and real estates markets (see Table 2). At the end of 2007, investment loans in securities were accounted for 10% - 15% of the total outstanding loans of commercial banks, up to 40% in some individual cases, leading to a "very hot" growth in these markets.

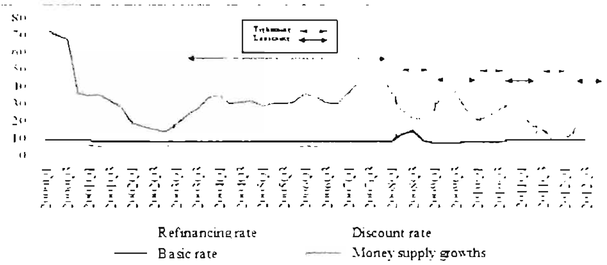
Table 2. Growth of Credit and Real Estates Credit, 2003 – 2012 (%)

Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Growth of Credit	28,4	41,5	19,2	21,4	53,9	26	37,7	27,7	12,7	6*
Growth of Real Estates Credit			25	9,8	8,5	35	15	19	-13.4	

* Note: estimated values

Source: Growth of Credit 2003-2011: IFS (2011), 2012: SBV; Growth of Credit for Real Estates: quoted from Le Xuan Nghia (2011).

Graph 3. Growth of Money Supply and Steering Interest Rates, 2000 – 2012



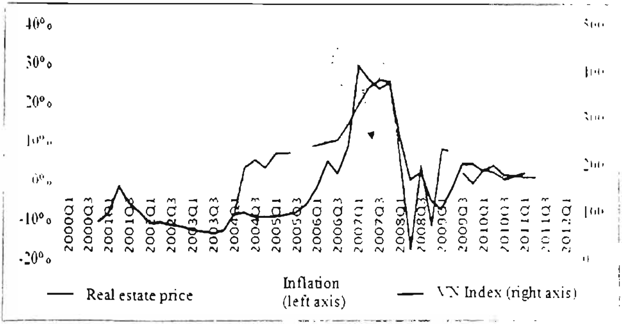
Source: Growth of money supply 2000-2011. IFS (2011). Growth of money supply 2012 and interest rates. SBV; expansion or loosening was based on money supply.

The growth of these high profitable investment channels immediately attracted external resources such as remittances and foreign direct and indirect investment. As the consequences, an even hotter growth of the stocks and real estates markets blew bubbles prices to the peak by the end of 2007 (Graph 4).

In early 2008, the monetary policy was tightened by a series of strong measures: i) increasing the required reserve ratio by 1%, requiring a compulsory reserve for all terms of loan (Decision No. 187/2008/QD-NHNN); ii) issuing VND 20,300 billions in compulsory treasury bills to all commercial banks (Decision No. 346/QD-NHNN); iii) controlling total outstanding loans, **discounting valuable papers** to keep stocks investment from exceeding 20% of charter capital of a credit institution, increasing the risk coefficient of a loan to real estates and stocks business to 250% (Decision No. 03/2008/QD-NHNN). By applying these measures, the State Bank of Vietnam (SBV) successfully broke the price bubbles; however, in the other hand, it also created big "shocks" to investors, regardless the application of some policy steps that were supposed to gradually diminish stocks investment. These "shocks" rapidly broke stocks bubbles and then real estates bubbles, leading to a free falling in these two markets (Graph 4). Meanwhile, a sudden tightening in monetary market formed a weak liquidity; as the results, interest rates were pushed up.

At the end 2008, while the economy experienced signs of economic recession due to the global crisis and before the launch of demand stimulus package, SBV actively emitted loosening monetary policies by i) slightly decreasing steering interest rates, ii) reducing required reserve ratio for term loans in VND from 8% to 6.5% then 3%, iii) encouraging commercial banks to expand credits and increase capital investment; and iv) issuing Decision No. 2321/QD-NHNN to increase interest rates of required reserve capital from 5% to 10% and Decision No. 2317/QD-NHNN to allow advanced payment on compulsory treasury bills.

Graph 4. Changes in VN-Index, Real Estates Prices and Inflation, 2000-2012



Source: VN-Index and Inflation: IFS (2011); Prices of Real Estates: from various sources

In 2009, the Government assigned SBV to operate a flexible monetary policy and assist commercial banks in providing loans at agreed interest rates. In action, SBV issued a number of documents: Circular No. 01/2009/TT-NHNN (guidance to Document No 1288/NHNN-CSTT) on agreed interest rates; Circular 02/2009/TT-NHNN on supporting short-term loan interest rates, Circular no. 27/2009/TT-NHNN on supporting medium and long-term loan interest rates SBV also reduced steering interest rates: from 8.5% to 7% for the basic interest rate, from 9.5% to 8% and then 7%/year for refinancing interest rate, from 7.5% to 6% and then 5% for discount interest rate to reduce interest rates and facilitate enterprises in accessing low cost capital sources.

In the first two quarters of 2010, inflation was strictly controlled that resulted in low growth rates of money supply (17% in Quarter I and 21% in Quarter II) and low inflation rates until August 2010. At that time, the economic growth rate in the first six month was only 5.57% which was lower than the set growth rate of 6.5% for the year. Under the pressure to gain the growth target, SVB implemented some adjustments: i) coordinating with the Banking Association to repeatedly reduce loan interest rates; ii) issuing a refinance loan of a VND 10,000 billions per bank to Vietnam Commerce and Industry Bank and Vietnam Bank for Agriculture and Rural Development. As the results, money-supply growth rates rapidly increase: 27% and 28% in the last two quarters that caused high inflation rates in the last months of 2010. At this time, monetary policy was reversed back to tightening. Basic interest rate was increased to 9% on November 5, 2010 after a 10-month period being unchanged at 8%. This was done at the end of the year when all businesses needed cash and therefore, caused serious liquidity constrains for commercial banks.

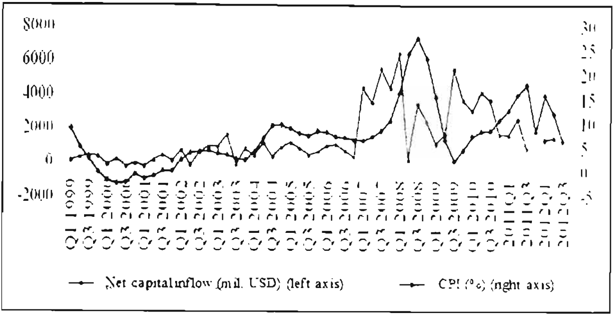
In 2011, SBV was consistent in controlling inflation target. The bank issued Directive No. 01/CT-NHNN on March 1, 2011 to maintain credit growth rate under 20%, increase total means of payment to 15% - 16%, and maintain the maximum loan proportion for non-manufacturing sector over the total outstanding loan at 22% and then 16% on December 31, 2011.

In addition, SVB was consistent in working towards the set goals by issuing the following policies: i) maintained term loans' interest rates under 14% (Circular No. 02/2011/TT-NHNN) and non-termed loans' interest rates at under 6% (Circular No. 30/2011/TT-NHNN); ii) continuously increased steering interest rates, and increased refinancing interest rate from 7% to 12% (nearly doubled) on March 8, 2011 and then to 13% on May 1, 2011; iii) applied monitoring measures to lending activities to non-manufacturing sector (Document No 2956/NHNN-CSTT on April 14, 2011, Document No. 8844/NHNN-CSTT on November 14, 2011); and iv) issued Directive No. 02/CT-NHNN 2011 on implementing regulations on interest rate, and Document No. 8839/NHNN-TTGSNH1 on November 14, 2011 on sanctions applied to Ho Chi Minh City Development Bank for violating regulations on ceiling interest rate . These drastic actions decreased the credit growth rate to 12.7% in 2011 from 27.7% in 2010, money supply growth rate to 15% from 25% at the same period of time. In 2012, monetary policy was kept at this tightening direction and credit growth rate was only at 7% in December of this year.

However, the tightening monetary policy also had side effects: i) high interest rates that enterprises could not afford, large inventory, and sharp decrease of industrial index; ii) frozen stocks and real estates markets; iii) increase in ratio of unqualified debts, especially in sectors that were required to be restructured as the consequences of the hot credit growths during 2003-2007 and 2009, as well as the credit structure adjustment in 2011.

Monetary Policy and Its Impacts to Exchange Rates

Graph 5. Capital Inflow and CPR by Quarters, 1999 – 2012

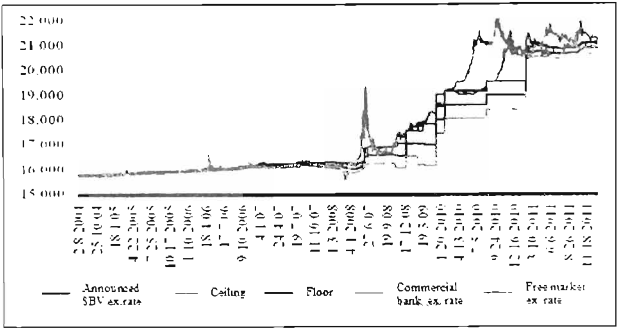


Source: 1999-2011: IFS (2011). 2012: SBV's website

Under the fluctuation of capital inflows and the pressure of an increasing exchange rate occurred at the end of 2007, SBV frequently adjusted average inter-bank exchange rates in an increasing trend and flexibly adjusted amplitude fluctuation of exchange rates. SBV also issued guidance to regulate activities of currency exchange, advertisement, listing, and buying-selling of foreign currency. It provided information on foreign currency supply and demand, especially on foreign currency reserves, announced ceiling interest rate of foreign currency applied to economic institutions (except credit institutions), committed to provide credit institutions who owned minus 5% or less of foreign currency, and requested the Government to require 7 State's economic groups and corporations to sell foreign currency. Adjustments were increasingly applied after May 2008 (Graph 5).

Despite these efforts, exchange rate still was not stable in a sustainable way until SBV devaluated VND by raising the average inter-bank exchange rate from VND 18.932 to 20.693 (by 9.3%) (Document No. 74/TB-NHNN on February 11, 2011). At the same time, the amplitude fluctuation was shrunk from +/-3% to +/-1% in accordance with Decision No. 230/QD-NHNN on February 11, 2011. This showed that the mechanisms to identify the nominal value of VND/USD exchange rate based on average inter-bank exchange rate and amplitude fluctuation has failed.

Graph 6. Intervention on Exchange Rates, 2007 – 2011



Note: → adjustment on exchange rate amplitude fluctuation;

→ adjustment on average inter-bank exchange rate.

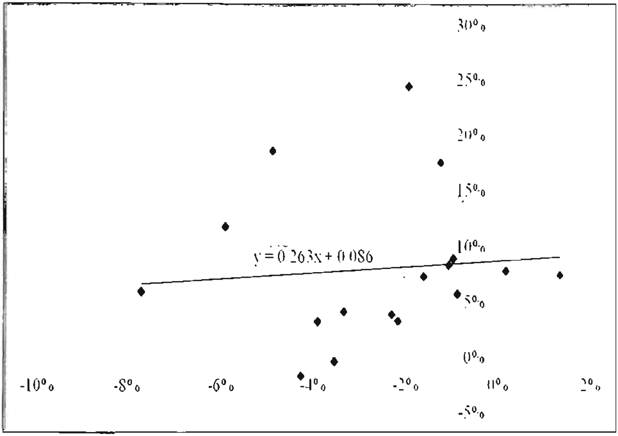
Source: Ha Thi Thieu Dao and authors (2012).

Fiscal Policy and Its Impacts to Inflation, Interest Rate and Debt

From 1992, Vietnam completely terminated the issuance of money to offset budget deficit and replaced it with borrowing. With this change, risk of budget deficit increase and inflation increase during period of 1995 – 2012 did not come from extra money being released in circulation but from State's budget advance. This was very risky for monetary policy implementation because increase in base money created inflation pressure. Moreover, there was a lack of legal documents to provide regulations on advance and payment, and sanctions for late payment. Besides, although SBV did not directly issue money, it re-bought Government bonds that previously were sold to commercial banks by the Government. This increased money supply in the economy and led to higher inflation. Data on correlation coefficient showed that budget deficit had a close relation with inflation. The larger the budget deficit was, the higher the inflation went (Graph 7).

Budget deficit caused an increase in loan's interest rates, followed by a decrease in private consumption and investment. A study of To Trung Thanh (2011) released that the government's investment during 1986 – 2010 negatively impacted private investment: immediate impact of public investment to private investment was lowest in the first year and most powerful in the fifth year. After a decade, every 1% growth in public investment led to 0.48% shrink in private investment and created only 0.05% to output growth. Besides, even when a systematic database to prove that increase in State investment from domestic and foreign loans caused an increase in interest rates was not available, it was clear to see that i) Vinashin accepted a very high interest rate compared to the average world's rate in order to borrow USD 750,000 in 2005; ii) The State Treasury applied high interest rates to be compatible with banks' interest rates in order to mobilize idle capital from population.

Graph 7. Relation between Inflation and Budget Deficit



Source: Calculated by the authors from data of IFS (2011).

Budget deficit worsened account balance and led to a risk of a twin deficit. Analyzing data on Table 3 showed that the deficit of Vietnam's account balance resulted from both Budget deficit and the negative difference in savings – investment of the private sector.

Large budget deficit in the long run caused a risk of public debt crisis. Table 4 presented the constant increasing in debt in order to help offset Budget deficit from 2002 to 2011, especially the increase in foreign debt. This was a threat to macro-economic stability.

Recently, Vietnam still maintained its foreign debt and public debt within a safe limit, but worrisome signs were showing: i) a sizable growth rate of lending, especially in 2009 when domestic loans rose by 63% and foreign loans rose by 84%; ii) worsening debt indices over time (Nguyen Chi Hai, 2011). This increased the negative impacts of foreign debt to macro-economic stability as high MII during 2008 – 2011.

Table 3. Ratio of Savings, Investment and State Budget Deficit, 1995 – 2012

Unit: %/GDP

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Saving-Investment	-8,9	-10,9	-8,2	-7,5	-3	-2,5	-2,4	-4,5	-8
The State Budget Deficit	-4,17	-3	-4,05	-2,49	-4,37	-4,95	-4,67	-4,96	-4,9
Trade Balance		-11,4	-4,9	-3,8	3,4	1,2	1,5	-3,0	-6,6
Current Account Balance		-8,3	-6,0	-4,1	4,1	3,6	2,1	-1,7	-4,9

	2004	2005	2006	2007	2008	2009	2010	2011	2012
Saving-Investment	-7	-5,3	-6,2	-13,9	-13,2	-10,9	-11,9	-6,06	
The State Budget Deficit	-4,85	-4,86	-5	-6	-4,58	-6,9	-6,2	4,9	4,8**
Trade Balance	-5,0	-4,6	-4,6	-14,7	-14,6	-8,2	-4,9	-8,1	0,20***
Current Account Balance	-2,1	-1,1	-0,3	-9,8	-12,4	-7,1	-4,1	-4,1	1,08*

*Note: * the first six months*

*** forecasted*

**** estimated*

Source: IMF, 2012: calculated by the authors from data on websites of SBV, the Ministry of Finance, the General Office of Statistics.

Coordination of Fiscal – Monetary Policies in condition of Macro-economic Instability

There was a good coordination between fiscal and monetary policies in the implementation of legal decisions related to interest rates. However, this coordination faced several shortcomings: i) Ministry of Finance (MOF) and SBV did not reach an agreement in identifying a strategic target. While the monetary policy was tightened for anti-inflation from the end 2008 and the end 2010 up till now, the fiscal policy was loosened or not tightened enough in a timely manner which reduced the effects of the monetary policy; ii) MOF and SBV has not coordinated well with each other in exchanging information on setting up and implementing policies. On February 29, 2012, "Regulation on coordination and information exchange" was signed by MOF and SBV.

These shortcomings reduced the confidence of population and businesses in regard to consistency of policies.

Table 4. Data on Debt to Offset Budget Deficit, 2002 – 2012

Unit: billion VND, %

Year	Domestic Debt to Offset Budget Deficit	Foreign Debt to Offset Budget Deficit	Budget Deficit	Proportion of Foreign Debt (%)	Proportion of Domestic Debt (%)
2002	18.382	7.125	25.597	27,8	71.8
2003	22.895	7.041	29.936	23,5	76.5
2004	27.45	7.253	34.703	20,9	79.1
2005	32.42	8.326	40.746	20,4	79.6
2006	35.864	12.749	48.613	26,2	73.8
2007	51.572	12.995	64,567	20,1	79.9
2008	48 009	19.668	67.677	29,1	70.9
2009	78.15	36.292	114.442	31,7	68.3
2010*	98.7	21	119.7	17,5	82.5
2011*	92.6	28	120.6	23,2	76.8
2012*	-	-	140,2	-	-

*Note: * estimated*

Source: Ministry of Finance and calculations of the authors.

Assessment on Policy Responses

Negative impacts from external changes were identified and therefore, appropriate responses were applied to the monetary and fiscal policies, such as i) anti-recession demand stimulus policy; ii) active monetary policy to reduce "overheated" development of the stocks and real estates markets and prevent a breakdown of property price bubbles.

Nevertheless, these responses still had side effects: i) loosening fiscal and monetary policy in 2009 for demand stimulus increased inflation and the budget deficit: ii) tightening monetary policy to reduce property price booming generated difficulties for commercial banks in liquidity and led to higher interest rates

Moreover, each policy had its certain shortcomings: i) highly-loosen monetary policy for the target of economic growth led to a "overheated" growth of the economy in 2007 – 2008: ii) fiscal policy without strict budget disciplines increased the budget deficit in a long run that led to a high inflation and the current account deficit as well as restrained private investment. iii) over-frequent issuance of monetary policies brought confusion and passives to objects and reduced policy's efficiency, iv) a lack of consistence in policy implementation. It was a common practice that monetary policy was tightened up at the beginning of a year for anti-inflation purpose, then when inflation was somewhat under control at the middle of the year, money supply was loosened for purpose of achieving economic grow, just to tighten up monetary policy again at the end of the same year; v) a lack of a long-term vision and steady targets with one-year aim only; (vi) having administrative nature, e.g. documents related to ceiling interest rates, Directive No. 03, the Government's Office Letter No. 02, etc., and (vii) inappropriate dosage with more of trial and errors, e.g. in determining nominal exchange rates, level of demand stimulus package in 2009 and growth rates of credit and money supply in 2011.

Causes of Policy Shortcomings

First of all, a lack of completed, updated, systematic database, especially quarterly and monthly database caused difficulties in accessing macro-economic variables for the study. This lack showed in data found on website of the General Office of Statistics, and in comparison of data achieved from Vietnamese source and foreign sources (IMF, WB). Moreover, Vietnam's management agencies have not paid appropriate attention to the building of a full and up-to-dated macro-economic data. They have not had an open-minded view in sharing information, partly because of the backward Privacy Ordinance and partly because they did not want to.

Secondly, a lack of independence in performance and institution of the State Bank. According to Nguyen Huong Giang (2010), the independence of SVB was in the lowest level. It can be seen in the current regulations: (i) SBV is not independent from the Government, but is managed and directed thoroughly by the Government both in organization and operation; (ii) SBV is not in charge of identifying inflation index; it is responsible only for determining targets of credit growth and money supply: iii) SBV is not the only agency to determine monetary policy tools since this is done with the Government's involvement; and iv) SBV's duty is to implement multi-targeted monetary policy, as specified in the Laws of the State Bank of Vietnam 2010

Thirdly, there was a lack of coordination in planning macro-economic policies. Recently, the coordination between MOF, SBV and related agencies was recorded in the National Advisory Council on Fiscal and Monetary Policy – the only agency gathering experts on fiscal and monetary policy together. However, this agency's function is giving advices and consultancies, not making decisions.

3. Policy Recommendations for Easing Macro-economic Instability in Vietnam

3.1. Viewpoints in operating policies

From the above analysis, we agreed that viewpoints in operating policies should be unified.

First of all, the economy must be operated in a dynamic state: i) changes in the economy as the operating environment of policy and business activities should be timely identified; ii) cyclical nature of the economy (both of Vietnam and the world) should be taken into account in adjusting strategic monetary and fiscal policies; and iii) in case of crisis, an interference should be actively and timely implemented to prevent the spread of negative impacts.

Secondly, inflation targeting mechanism should be implemented. Currently in Vietnam, the priority target is curving inflation through inflation targeting mechanism due to benefits that it brings: creating disciplines in policy implementation, ensuring consistency in policy enactment and realization, and enhancing the market's confidence in the government's policy.

3.2. Solutions for Macro-economic Stability

Adjustments in monetary policy include: i) applying of flexible exchange rates Like other countries, Vietnam can not simultaneously implement three tasks of macroeconomic policies: stabilizing exchange rates, liberalizing capital flows and operating independent monetary policy At present, Vietnam has opened to allow non-residents to own financial assets under WTO commitment. Therefore, reducing interference and letting exchange rate to reflect market supply – demand relationship is the best choice of Vietnam; ii) respecting market mechanisms. Interest rates should be determined by the markets with supervision of SBV In case of interest rate race, SBV shall interfere to stabilize the market through inspection and supervision to prevent too-high interest rates rose by commercial banks for profit and assure safety, efficiency and stability of the banking system; iii) building data and statistics, based on which precise prediction shall be made and policy shall be formulated. Thus decisions shall be made ahead, not behind market changes and "shocks" to the monetary market in particular and to the economy in general shall be mitigated and no longer exist; (iv) strictly abiding the rules of information provision, policy issuance and implementation to reduce the trial and error in order to avoid negative responses from the society and the markets and increase enforcement of policies; and (v) identifying the appropriate medium and long term objectives of the government's fiscal policy and supporting the implementation of this policy.

Adjustments in fiscal policy include: (i) ensuring financial disciplines, (ii) completing the budget statistic system according to the international rules. The current differences between Vietnam's and international rules in statistic system do not allow to compare Vietnam to other countries and lead quite differences between data from Vietnam and the world's financial institutions, such as International Monetary Fund (IMF), the World Bank (WB). Statistic data on the state budget from Vietnam are usually not reliable, causing suspicions; (iii) balancing the expenditure and the amounts of domestic and foreign debt so as to cover the state budget deficit; (iv) ensuring sources of the budget revenue; (v) rationalizing the budget expenditure; and (vi) setting the task of reducing the budget deficit as the top priority of the fiscal policy.

An appropriate and specific roadmap for reduction of the state budget deficit includes: (i) reviewing all sources of revenues and expenditures, using international rules in accounting; (ii) reviewing funding mechanisms of the central and local budgets to prevent deficits in the central budget but excesses in local budgets, and (iii) enacting the Laws on Public Investment as a foundation of restructure of the economy and state-owned enterprises.

Apart from these, the National Monetary Policy Council should be responsible as policy makers, not as policy consultants as present. SBV should be empowered in implementing monetary policy to curve inflation./.

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