**Inflation Targeting in Vietnam**

This note outlines what inflation targeting (IT) involves for Vietnam and discusses the advantages and challenges of implementing this monetary policy framework. For Vietnam, the trade-off between high growth and low inflation suggests IT is not yet appropriate in the current economic climate, but may prove to be a feasible alternative in the medium term.

Vietnam has a long and well-documented history in the fight against persistently high inflation. In recent years, the reemergence of high inflation has seen public discourse surrounding the appropriateness of monetary policy reaching new heights. This note provides an introduction to Vietnam’s current monetary policy framework and discusses IT as one viable alternative to the status quo.

**Monetary policy 101**

Monetary policy describes the process of how a monetary authority (government or central bank) controls the supply of money to stabilize inflation (growth in prices) and to some extent, the labor market in an economy. The goal of price stability is achieved by exploiting the relationship between money and prices. In particular, market transactions by the monetary authority alter the money supply and this impacts other market variables such as short-term interest rates and the exchange rate.

In practice, monetary policy can take many forms, with the set of instruments and target variables used by the monetary authority, the distinguishing feature. Where interest rate channels alone are too weak, for example, reserve requirements and credit growth targets can also be employed. In addition, international trade further complicates the combination of tools used in implementing monetary policy. Specifically, international arbitrage (profiteering from global price imbalances) means that it is impossible to simultaneously implement a fixed exchange rate, free capital flows and an independent monetary policy. This is a particularly difficult challenge for Vietnam to overcome (later discussed).

**Monetary policy in Vietnam**

Since the mid-1990s, the State Bank of Vietnam (SBV) has controlled the supply of money in Vietnam by targeting interest rates, with some success (figure 1). Specifically, a basic interest rate is announced by the SBV each month and achieved via open market operations, that is, the purchase and sale of government bonds to change the short-term interest rate and base-money supply.

![Figure 1: Inflation and interest rates in Vietnam](image)

Source: IMF and DEPOCEN.

1. A problem typically referred to as the ‘Impossible trinity’.
These changes are transmitted through the economy due to restrictions placed on the margin (difference) with other, more common rates such as refinancing and deposit rates. The rate chosen by the SBV is expected to be consistent with the National Assembly’s annual inflation goal for the year ahead. In other words, Vietnam employs an underdeveloped style of IT, where targets are made in the short term and subject to change.

**What is inflation targeting?**

While the mechanism for transmission remains clear, medium-term goals are distinctly absent from current monetary policy in Vietnam. Much discussion has thus turned to the use of inflation targeting as one way to control prices (thus preserving the value of money) and support long-term growth in the economy.

In its more recognizable form, IT consists of an inflation target (usually CPI) as the centerpiece of a monetary policy framework that seeks to control inflation over a *medium-term* horizon. However, simply announcing a target is not sufficient. Crucially, an IT regime places additional requirements on the monetary authority to maintain:

- an unwavering commitment to price stability above all other goals (including growth, employment etc.) and operating with some degree of independence;
- substantial use of *forward-looking* indicators;
- transparency regarding policy objectives; and
- accountability via regular reports, statements and other communication channels.

Put simply, IT requires more than just statement of a target by the monetary authority. Thus, rather than a silver-bullet solution, IT can be thought of a monetary regime comprising of a number of essential ingredients. If successfully implemented, IT can lead to a substantial reduction in economic volatility due to the strengths of this policy framework. Some of these strengths are discussed below.

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4 The medium term can be thought of as the length of an “average” economic cycle, with the past two economic cycles in Vietnam lasting around 10 years.

Advantages

- An IT framework allows a monetary authority to more easily respond to domestic demand shocks, particularly with respect to the household and business sectors.

- **Flexible** targeting – Depending on a country’s stage of economic development, a well-designed IT framework should be flexible enough to accommodate most short-term demand shocks in an economy. For example, Vietnam could initially implement a weak form of inflation targeting with wide bands to accommodate growth and over time, progress towards stricter forms of inflation targeting such as tighter bands or a lower target (see Figure 2).

- Unlike monetary policy tools which rely on physically altering the money supply (currencies and deposits in circulation), IT is straightforward to implement. In setting interest rates, the ability for a central bank to buy and sell government securities to alter the interest rate is seen as a credible threat. As a result, merely announcing a new target is sufficient for banks to alter the lending rates.

- **Transparency** is perhaps one of the most overlooked advantages of an IT framework. Simple IT rules demystify monetary policy and provide an environment for significantly greater engagement in policy debate.

Major challenges

While an inflation targeting regime can contribute to significant stabilization in the macro-economy, initial implementation requires overcoming two major challenges.

- **Institutional conditions:** By far the most difficult challenge to overcome in Vietnam. Necessary conditions often include broad-based institutional reform in financial markets (liberalization including greater competition in the credit sector, international integration) and labor markets (welfare, minimum wage safety nets, flexible work practices). Also essential are refinements in judicial and legislative systems to ensure independence of the central bank is all essential. In short, greater microeconomic reform needs to occur before macroeconomic benefits are visible.

- A **tri-lemma:** Simultaneously achieving perfect capital mobility, a fixed exchange rate and independent monetary policy is impossible due to international arbitrage in financial markets (the impossible trinity). As a result, adopting two of these policy tools automatically means forfeiting the third (figure 3).

**Figure 3: The impossible triangle**

Vietnam’s reliance on FDI and a pegged exchange rate to the US dollar, sovereign monetary policy is essentially sterilized. In other words, the availability of monetary policy as a tool to control inflation in Vietnam means either strict international capital controls or a significant intervention in the foreign exchange market will be necessary, both of which will reduce growth in the short term. To mitigate this problem, many inflation targeting countries have opted to float their currency prior to the introduction of an inflation target (UK, Canada, Australia) or enforce strict capital controls (China).
Implementation

Abstracting from these two initial challenges, a raft of implementation issues remain.

- **Fiscal influence**: In the absence of an independent monetary authority, inflationary pressures resulting from fiscal policy can undermine the effectiveness of monetary policy by forcing the central bank to accommodate the demands of the government.

- **Design**: Controlling inflation is difficult! Inevitably, circumstances will arise whereby inflation targets will be missed. Careful consideration must be given to the magnitude and size of the inflation target interval. A poorly designed IT regime will be ineffective if it is too ambitious or inflexible in the short term. Australia’s policy, for example, is carefully designed so that a 2-3 per cent target is achieved “on average” over the medium term. The credibility of this inflation target has meant that the cash rate is now essentially a leading indicator of inflation (figure 4).

**Figure 4: Inflation and interest rates in Australia**

![Chart showing inflation and interest rates in Australia](chart.png)

Source: Australian Bureau of Statistics and Reserve Bank of Australia.

- **Timing**: The effectiveness of IT is largely dependent on anchoring expectations. Rushing ahead with this regime before institutions are ready could lead to disastrous consequences (volatility in growth, exchange rates etc.). Chile and Australia provide good case studies to effective implementation, including prior legislated independence for the central bank, sound fiscal policy (surplus budgets), strong banking regulations and implementation when inflation was currently low (to anchor expectations).

- **Resources**: The forward looking nature of IT requires a firm understanding of the economic climate and thorough use of reliable historical relationships. In other words, IT is heavily dependent on receiving a raft of quality statistics. In addition to these data needs, central banks must also dedicate considerable resources to the timely production of monetary policy advice - minutes from monthly monetary policy meetings, quarterly forecast reports on the state of the economy, speeches etc.

- **Benchmarking success**: Like most policy measures, assessing the effectiveness of IT is inherently difficult due to the lack of a counterfactual (i.e. the economy under a baseline scenario). However, aside from the obvious indicators of growth and inflation outcomes, some indicators to examine include medium-term volatility in the business cycle before and after regime implantation and cross country comparisons.

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7 For a recent evaluation by the IMF (2010), see *Inflation Targeting Turns 20*, Finance and Development, Vol. 47, Number 1.
Navigating the road ahead

Evidence suggests IT is an extremely effective method to implement monetary policy. The combination of simple to understand and transparent targeting rules provide a powerful means to reduce and maintain low inflation. However, the past experience of countries implementing IT suggests a significant number of challenges persist for Vietnam before the country is ready to implement this regime.

A well-planned roadmap is therefore necessary to lay the foundations for an IT framework. These have been outlined in the major challenges and implementation sections of this note. As a start, deep reform in the non-competitive financial sector, improving labor market conditions and granting independence to a central bank with a medium-term goal are necessary.

Over the medium term, recognizing the existence of the impossible triangle will determine what the priorities for Vietnam are. In short, growth will need to take a backseat to fighting inflation, with either strict capital controls or a more flexible exchange rate required. Only then in the longer-term can Vietnam even attempt to implement IT, a goal that is ambitious in itself.

Again, it should be repeated that IT alone is not a silver bullet. However, even if IT is ultimately not implemented, progressing along this previous roadmap will result in substantial reductions in economic volatility.