Project title: Taylor rule and optimal interest rate policy in Vietnam

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Prize: Consolation prize at UEB level

A widely agreed proposition in modern economics is that policy rules have greater advantage over discretion in improving economic performance. Simple monetary policy instrument rules are feasible options for developing countries lacking the pre-requisites for more sophisticated targeting rules. Notwithstanding the focus of modern literature on the issue, the State Bank of Vietnam (SBV) has never declared itself to be following any type of rule. Surprisingly, this topic has remained out of research focus (among the academia and the practitioners) in Vietnam. Therefore, it requires researcher and policy makers investigate more time and effort to research this topic thoroughly.

This study attempted to find the optimal interest rate policy for Vietnam by investigating the effects of several repressors variables including the output gap, inflation gap and exchange rate on the short-term interest rate based on the Taylor rule approach, using quarterly data of Vietnam over the period 2000-2011Q2. No evidence that the State Bank of Vietnam followed the Taylor rule was found. Both counterfactual and stochastic simulation results confirmed that Vietnam's macroeconomic performance would have been improved, in terms of stability in inflation and output, if a simple Taylor rule had been adopted. Finally, a fairly high weight on the inflation and a low weight on the output were found to be the optimal choice of the State Bank of Vietnam in the conduct of interest rate policy. It means in long-term, SBV should continuously follow increasing output growth as the priority object, the second object is controlling inflation.