

## **Demand for Money in Dollarized, Transitional Economy: the Case of Vietnam**

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### **Abstract**

The negative correlation between broad money and inflation emerged after the outburst of Asian financial crisis. It poses a puzzle if it is interpreted within a widely accepted macroeconomic framework in which the growth of money supply and inflation positively correlate. This paper solves the puzzle by decomposing the demand for money into the demand for domestic currency and the demand for foreign currency in view of the fact that Vietnam is highly dollarized. The empirical analysis employs cointegration, error correction model, impulse response and variance decomposition and uses quarterly data over the period 1993-2004. The results show that the long run demand for real broad money of domestic currency is determined by real income, domestic interest rate, inflation rate and rate of return of USD deposits, which satisfies the standard properties of the demand for money. The long run demand for real foreign currency deposits is determined by real income and the difference between rates of returns of foreign and domestic currency deposits, that represents asset substitution. Demand for real foreign currency deposits is found to be very sensitive to the difference between rates of returns of foreign and domestic currency deposits, especially exchange rate depreciation. A positive difference between rates of returns of foreign and domestic currency deposits triggers a shift from domestic financial assets and real assets to foreign financial assets, resulting in a lower inflation rate and a strong increase in demand for foreign money. When this effect is very strong, then even an increase in broad money, including foreign currency deposits, may negatively correlate with inflation.

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