

VIETNAM DOLLARIZATION: FACTS AND SOLUTIONS

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Vietnam, as a developing country, has been highly dollarized since the early 1990s and this problem has greatly deteriorated in recent years. However, high level of dollarization is not always a disadvantage in different economies. In fact, the world saw some countries achieve success in their initial stages of dollarization such as Zimbabwe in its attempt to curb inflation and Cambodia to attract FDI. This paper is to deal with the forms of dollarization and its advantages and disadvantages and then present the facts of Vietnam's dollarization and solutions to this.

Keywords: dollarization, bank deposit, inflation, balance of payments

1. What is dollarization?

Dollarization is the use of foreign currency to replace one or more functions of the domestic currency. According to a definition of dollarization by IMF, a highly-dollarized economy is one in which foreign currency deposits account for more than 30% of the extended money stock (M2) consisting of cash, demand deposits, time deposits and foreign currency deposits. There are three common ways to categorize dollarization, viz. direct vs. indirect dollarization, full vs. partial dollarization, and official vs. unofficial dollarization.

- Direct dollarization is the use of foreign currency as a unit of account, a means of payment and a store of value (especially in form of deposits and bank credit). As for indirect dollarization, it is the issuing of government bonds and corporate bonds in foreign currency to international markets or the indexing of domestic debt contracts in foreign currency.

- Full dollarization occurs if a foreign currency is considered as a single currency in use whereas partial dollarization is the use of both domestic and foreign currency in the same country. In such countries, foreign currency is used in accounting, making payment and trading along with the

domestic currency, in which the former functions as a second legal tender. Bolivia and Cambodia are among fully dollarized countries.

- Official dollarization exists if a foreign currency is accepted by law to perform the functions of the domestic currency in transactions and monetary contracts. For example, in Panama and Ecuador, the governments officially substituted the US dollar for their abandoned domestic currencies. In contrast, if a foreign currency is not legally acknowledged, but in reality, it is used in transactions and monetary contracts, then the case is called unofficial dollarization.

2. Dollarization in some parts of the world

The history of international currency lately witnessed different levels of dollarization.

Levels of dollarization can be divided into three descending groups (Reinhart, 2003). In highly dollarized countries, such as Cambodia and Bolivia, some 90% of bank deposit are in foreign currencies. Meanwhile, the figure is recorded at below 10% for those countries with low level of dollarization like Chile and Malaysia. As can be seen from the table, there was a growing trend in levels of dollarization in the period 2000-2004.

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RESEARCHES & DISCUSSIONS

Table 1: Dollarization (Foreign currency deposit as % of bank deposit)

	1990	1995	1998	1999	2000	2001	2002	2003	2004	95-04
High level of dollarization										
Combdodia	...	92	93	92	93	95	94	95	96	94
Bolivia	82	78	92	93	92	92	92	93	87	90
Uruguay	86	79	79	81	82	85	88	89	88	84
Ecuador	13	19	37	54	100	100	100	100	100	76
Lao PDR	18	57	76	90	85	83	71	31	33	66
Peru	46	65	64	66	68	66	73	70	68	68
Argentina	47	57	58	62	65	74	1	2	4	40
Medium level of dollarization										
Vietnam		21	24	26	32	28	23	23	22	25
Russia		29	44	41	37	34	35	27	28	34
Philippines	21	25	33	32	32	31	30	31	32	31
Indonesia		20	22	19	21	20	17	16	15	19
Israel	28	19	21	19	19	19			15	19
Low level of dollarization										
Chile	19	5	6	9	9	11	11	12	10	9
China			8	8	9	8	7	6	5	7
South Korea	1	1	5	3	3	4				3
Malaysia			2	3	3	4	3	3	3	3
Thailand	0,1	0,3	1	1	1	1				1

Source: Patricia Alvarez Plata – Alicia Garcia Herrero – DIW Berlin 12.2008 and SBV

a. Impacts of dollarization:

+ Advantages:

- Dollarization helps prevent currency and balance of payments crises. Without domestic currency, there will be no abrupt devaluation or sudden capital outflows caused by concerns about devaluation.

- Further integration into the global economy will be less costly. Besides, dollarization guarantees stable prices as per the dollar or the selected foreign currency.

- Dollarization is employed in some countries as a means to restrain inflation and promote the roles of their financial institutions, and stimulate both domestic and foreign investment.

+ Disadvantages:

- Dollarization causes macro-instabilities and high inflation (Reinhart et al, 2003), for instance in Argentina, Bolivia and Uruguay in the late 1980s. Moreover, it makes monetary policies more complicated and less effective. Fluctuations in exchange rates are wider when people change currencies according to changes in prediction of

the supply of domestic currency, which affects badly the money market (Calgo and Vegh, 1996).

- A fully dollarized country tends to deprive itself of the possibility of having independent monetary policies and exchange rates, including the right of the central bank to provide commercial banks in need with liquidity. This takes away the inherent role of the central bank. A case in point is Cambodia where the National Bank of Cambodia (NBC) failed to influence its money market and control inflation. Movement of credits in the private sector went beyond NBC's control. The country's extended dollarization forced NBC to accept the U.S. monetary policy. As a result, when NBC gradually applied the dollar reserve requirement ratio (RRR) in its monetary policy to manage liquidity, it proved to be of little effect (in late November of 2010, the dollar RRR was 12% while the ratio for the riel was only 8%). In 2009, a decrease in RRR created more liquidity and stimulated economic growth during the global financial crisis (Nombulelo Duma, 2011).

- The substitution of a foreign currency for a country's domestic currency can badly affect its national emblem and cause internal political conflicts.

- In an economic view, the power of a government to issue money brings it seigniorage. Therefore, in a dollarized economy, this profit goes to the U.S. Federal Reserve, unless an agreement on shares is made between them. The cost of dollarization is calculated by multiplying the dollar volume in circulation by the annual dollar interest rates in the U.S. (Federal Fund Rate, prime lending rate, etc.). The cost was recorded at 0.1 – 0.5% of GDP in Cambodia; 0.5% and 7.5%, Argentina and Ecuador, respectively, in the period 1991-1997 (Nombulelo Duma, 2011).

b. Lessons on successful dollarization in some countries:

Experience of successful struggle against dollarization, according to Reinhart, Rogoff, and Savatanos (2003), come from two groups. The first one includes countries that employ administrative measures, such as Argentina and Mexico; and the second ones, like Israel, Poland and Pakistan, where market instruments are used. Some lessons on this issue are as follows:

- Policies gradually adjusted to market principles are more likely to pay off. In some countries such as Chile, Egypt, Israel, and Poland, policies on reducing inflation and financial depth helped diminish dollarization. They are concerned with (Erasmus, Leichter, and Menkulasi, 2009):

(i) Issuing bonds in domestic currency,

(ii) Announcing bonus interest rates on required reserve for deposits in foreign currency

(iii) Supervising banks' operations to ensure their ability to repay their foreign currency loans.

- Administrative measures for dollarization reduction can cause macroeconomic instabilities: In 1982 and 1998, Mexico did not achieve expected results in taking administrative measures to convert foreign currency into domestic currency at an exchange rate lower

than the market one. This was followed by a capital flight and a decrease by half in credit of private banks in two years, influencing the country's economic growth and leading to soaring inflation (Reinhart, Rogoff & Savastano, 2003). In cases of Bolivia and Peru, forced change of foreign currency into domestic one has produced macroeconomic instability and hyperinflation with the result that the deposit in foreign exchange was allowed.

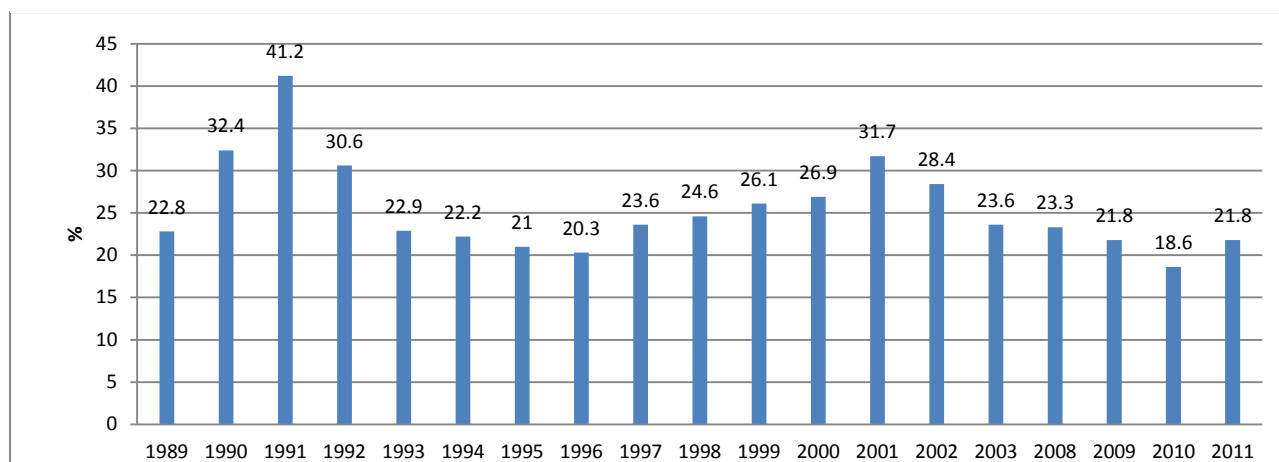
- Combating dollarization is not a simple task but a process of gradual adjustments. According to Balino, Bennett and Borensztein (1999), the task is a real hassle, depends on institutional changes and is possible only if benefits from currency conversion are obtained. It also requires inflation reduction and a policy on macroeconomic stabilities (Erasmus, Leichter and Menkulasi, 2009). Building faith in the policy is just as important.

3. Dollarization in Vietnam

Figure 1 shows that Vietnam is ranked among the top highly dollarized countries in Asia and worldwide with its foreign currency deposits making up 20%-40% of bank deposit. Based on the aforementioned classification, Vietnam is categorized as dollarized directly, partially, and semi-officially (in terms of bank credit in the official exchange market and the black market).

Many a research has been conducted to find the causes of Vietnam's dollarization. The primary cause is the economy's weaknesses and prolonged high inflation which resulted in the devaluation of the VND and a loss of faith in it. Second, it is due to low economic interests and inconvenience in using the VND (poor convertibility and payment power, and low values, etc.). Last, the dollarization is attributed to the use of foreign currency in mobilizing capital, collecting taxes, making payment, quoting prices, etc. This is not a profound and direct cause, but it has actually worsened dollarization, especially in Vietnam.

Figure 1: Proportion of foreign currency deposits to bank deposit



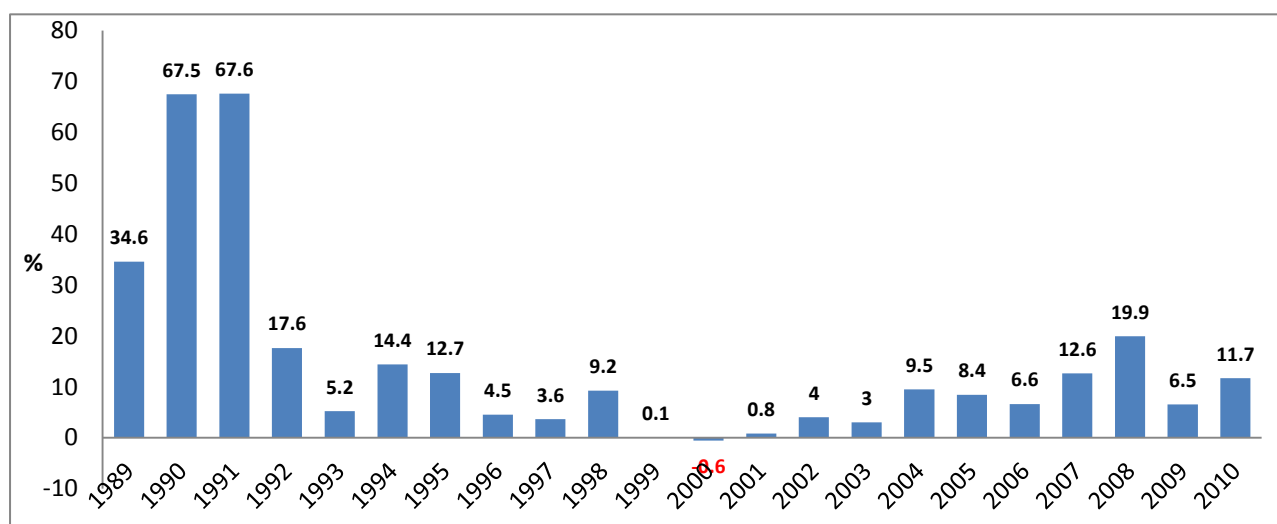
Source: Andreas Hauskrecht, Nguyễn Thanh Hải – SBV

In analyzing the dollarization level in Vietnam, however, development of financial sector and global economic integration must be taken into account. Specifically, the country's inflation in 2010 was 11.7% as against -0.6% in 2000; however, there was a reverse trend in the dollarization level recorded at 18.6% in 2010 compared to 26.9% in 2000. The trend is put

lately undergone a fast growth and the banking system has been expanded. As a result, banks become a more convenient channel of mobilizing VND from privately-held savings. Besides, the total liquidity (M2) increased quite quickly in the period 2000-2010: M2/GDP in 2010 rose to 120% from 60% in 2000.

Dollarization can be beneficial in some cases:

Figure 2: Vietnam's inflation in 1998-2010



Source: GSO

down to the fact that the financial sector has increasing supply of foreign currency, stimulating

RESEARCHES & DISCUSSIONS

Table 2: Balance of payments – percentage of dollarization in Vietnam

BOP (1)	(US\$ billion)	2009	2010	3/2011
	On current account	-6.02	-4.25	-4.00
	On capital account	6.67	5.55	6.00
	Errors	-10.26	-4.36	-1.00
	BOP	-9.52	-3.06	1.00
BOP (2)	(US\$ billion)	2009	2010	3/2011
	Gross receipts of foreign currency	97.80	118.60	238.00
	Gross expenses of foreign currency	97.03	117.30	236.00
	Surplus	0.77	1.30	2.00
Dollarization percentage	(%)	2009	2010	3/2011
	Foreign currency deposits+gold/total deposits	21.83	18.56	21.84
	Foreign currency deposits+gold/M2	19.14	17.04	18.18

Source: National Financial Supervisory Commission of Vietnam

flows of international goods, minimizing exchange rate risk, reducing transaction costs and capital charges, helping protect people's interests in case of high inflation. Nonetheless, the high level of dollarization in Vietnam is imposing adverse effects on the country's macroeconomic situation and financial market.

Firstly, dollarization makes the monetary policy of Vietnam strongly governed by external factors, especially the U.S. monetary policy and changes in the global finance market where the US dollar functions as a primary means of investment and speculation.

Secondly, dollarization is a hindrance to forecasting the total liquidity, leading to less accuracy in making decisions on increase/decrease in the money volume in circulation. Moreover, it makes domestic currency susceptible to interest rates of the international market through foreign currency interest rates. Thus, efforts to affect the aggregate demand

through interest rate in domestic currency become less effective.

Thirdly, Vietnam's banking system has its liabilities and assets dollarized. Therefore, imbalance in supply and demand for kinds of currencies usually takes place because of frequent changes of domestic currency into foreign ones and reverse caused by upheavals in the exchange rate and interest rates. Thus, exchange rate risk becomes a common one in the banking system and finance market as well.

Fourthly, with macroeconomic instabilities and poorly transparent exchange rates, dollarization stimulates the withholding of foreign currency by the population, businesses, and commercial

banks. This creates intense pressure on exchange rates and foreign exchange reserves of the SBV even when supply of and demand for foreign exchange are in balance (the gross expenses of foreign currency is still smaller than the gross receipts.)

Fifthly, with gold as a more reliable means of investment (than the USD) in a dollarized economy, the exchange and mutual replacement of gold and foreign currency become easier to accomplish. This causes unusual changes in the supply of and demand for foreign currency (due to gold smuggling) and creates pressure on the international balance of payments and exchange rates. Vietnam has a gold reserve worth about US\$20 - 47 billion or weighing approximately 1,072 tonnes. The reserve is mostly held by private persons while the official reserve is very small. As a result, the SBV has little chance to intervene in the gold market in Vietnam (*Economic Development Review*, February 2011)

Sixthly, Table 2 indicates that errors in Vietnam's balance of payments are too large: US\$10.26 billion in 2009, 4.36 billion in 2010 and an expected one billion in 2011. It is mainly because of the US dollar in the free market is used to illegally import gold which is then held by the public instead of banks. This situation results in deficit in the balance of payments and dramatic reduction in foreign currency reserves, and worsens dollarization. More importantly, this occurs outside the banking system.

4. Measures to fight dollarization in Vietnam

Vietnam's dollarization reduces the quality of the planning and implementation of its monetary policy. It is also an obstacle to supervising financial institutions and brings about great risks to the banking system and the finance market as a whole.

For concerns about systematic risks (crises in balance of payments and banking system), some countries carried out various measures to completely abolish dollarization, which can be divided into three groups:

- Measures to restore macroeconomic stability consist of adopting strict fiscal and monetary policies to control the aggregate demand, fight inflation and raise the real and face value of domestic currency.

- Measures based on market tools include bidirectional policies dealing with holding and speculating foreign currency; reasonable differences between interest rates on deposits in foreign and domestic currencies with the latter favored; and development of derivatives (forwards, futures, foreign exchange options, swap contracts, etc.) to prevent exchange rate risks and establish a modern market for foreign exchange.

- Administrative measures include provisions on compulsory sale of foreign exchange to banks; a ban on using foreign currency to make payment in the domestic market; limits on deposits and loans in foreign currency (applied in Angola, Argentina, Israel, Lebanon, and Turkey, etc.). However, some measures, such as compulsory

conversion of foreign currency into domestic currency or the temporary freeze of foreign currency deposit accounts to prevent withdrawals, proved to be ineffective (in Bolivia, Mexico and Peru) and even caused inversion in foreign capital flows and broke up some financial institutions.

The fight against dollarization in Vietnam is a complicated process requiring co-ordination of economic measures and instruments of monetary and fiscal policies. Besides, it is necessary to take administrative measures at a reasonable extent and good timing in such dollarization economies as Vietnam.

According to the above-mentioned analyses, the combat against dollarization in Vietnam should be accompanied by macroeconomic stabilizing plans, specifically by means of consistently implementing measures specified in the Decree 11. There are some other approaches for Vietnam to follow:

First, useful economic measures are: (1) Increasing required reserve ratio for foreign currency deposits accordingly with banks' liquidity to lower the deposit rate and raise lending rates on foreign currency loans; (2) Adjusting foreign currency status from $\pm 30\%$ of charter capital to $\pm 20\%$ to deter the retention and speculation of foreign currency in commercial banks; (3) Gradually lowering interest rate ceilings of foreign currency deposits accordingly with the progress in changing RRR to limit deposits in foreign currency and stimulate deposits in VND; (4) Applying agreed-upon exchange rates based on the rates of the previous day announced by the SBV, and establishing a modern and transparent official foreign exchange market; and (5) Developing a derivatives market.

Second, it is concerned with administrative measures: (1) Forcing state-owned companies to sell foreign exchange they earned to banks in order to fight the retention of foreign currency; (2) Imposing a limit on foreign currency loans to customers who have no source of income in foreign currency; (3) Compelling businesses to

convert foreign currency deposits into demand deposits at the lowest or zero interest rates; (4) Controlling and punishing the use of foreign currency in making payment in the domestic market (including the charging and quoting prices in foreign currency); (5) Controlling the trading in foreign currency in the free market and phase out deposits and loans in foreign currency when inflation is kept in check; (6) Amending current provisions on foreign exchange management, including immigrant remittance, in a effort to transform deposits and loans in foreign currency into trade in foreign currency in the official foreign exchange market.

In conclusion, Vietnam has for a long time witnessed dollarization which had its adverse and long-lasting impacts on the economy. Therefore, an appropriate strategy and policy should be taken into consideration to diminish dollarization. Moreover, it is essential to combine administrative measures with those based on market rules to settle the finance market and ensure the macroeconomic stability■

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