AN EXCHANGE RATE SYSTEM IN THE INTEGRATION PROCESS

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Since the 1990s, the Vietnamese money market has witnessed a changing and unpredictable exchange rate and a lot of experience could be drawn from the past to choose an optimal exchange rate system that is suitable to the integration process.

1. Looking back on the past exchange rate system

At the beginning, the official exchange rate was publicized by the SBV as a fixed rate of the VND to the dollar while the rate of the VND to other currencies were floated and based on cross rates. The unofficial rate was usually higher than the official one because of expectation of the revaluation of the VND. In 1991, the idea of an equilibrium rate of exchange determined by the supply and demand forces led to formation of two foreign exchange trading centers in Hà Nội and HCMC. In fact, shortage of foreign exchange needed for international payments forced commercial banks to sell foreign exchange in order to support the official rate as required by the SBV. The volume of trading required by the SBV in the order of US$1 million a week was very small in comparison with the volume exchanged between banks and private persons and companies, which proved that the role of trading centers was no longer suitable. In 1994, regulations about the inter-bank market for foreign exchange introduced a new transaction method in which the Reuters network was used for increasing the trading volume although it was still smaller than the trading volume on the free market. The official rate of the VND to the dollar and other currencies was associated with a narrow band. The exchange rate offered by the inter-bank market had no close relation with the official rate. Wide fluctuations in the rate of the dollar to other hard currencies made the rates of the VND to non-dollar currencies publicized by the SBV always very different from the cross rate forcing the SBV to abandon the mechanism for fixing rates of the VND to non-dollar currencies.

The Asian financial crisis breaking out in Thailand in July 1997 required adjustments to the rate of the VND to the dollar. In addition, the policy to force commercial banks to sell foreign exchange to the SBV helped increase the supply on the foreign exchange market and made the exchange rate more suitable to market forces by introducing an inter-bank exchange rate with a fixed narrow band.

The principal feature of the exchange rate policy in the past 12 years was the formation of a "periodically fixed exchange rate because of effects caused by macroeconomic factors and changes in the financial situation of the world and regional markets. This model was adopted because Vietnam in its transition from the centrally planned mechanism to the market economy lacked input information needed for making the exchange rate policy. For example, the trade balance under the barter mechanism was distorted; external debts that needed to be restructured didn't supply necessary information and produce rational expectation of a more favorable exchange rate; there was no market for the domestic currency that reflected changes in the supply and demand forces and helped the SBV regulate the money supply; the dollarization was widespread, etc. The urgent problem today is to choose an optimal exchange rate system that meet requirements posed by the integration process.

2. Criteria for deciding an exchange rate policy

In my opinion, the following are necessary criteria:

- The exchange rate policy must help stabilize the money market. Interaction between interest rate and exchange rate is affected by the central bank's reserves.

- The exchange rate system must improve the competitiveness of local goods on both foreign and domestic markets and help create favorable conditions for turn the deficit balance of payments into a surplus one.

- The exchange rate system must help increase the capital inflow steadily and make the business climate less risky, thereby turning the surplus capital account a basis for improving the balance of payments.

- The exchange rate system must generate rational expectation for the market based on information about basic indexes publicized.

- The exchange rate policy must deal with two current problems: Vietnam's external debt is still vary big and its currency isn't convertible. The exchange rate system must turn it into a convertible one and reduce burden to the external debt. In addition, it must help increase the foreign exchange reserve needed for the SBV intervene in the foreign exchange market.

- Finally, the exchange rate system must be supported by instruments for reducing the exchange risk. Commercial banks need government's permission to introduce new instruments, such as options, forward contracts, interest rate swap, etc. These instruments will improve the liquidity of the market, and more importantly, reflect the market expectation – a sign on which the central bank can take action timely.

3. A flexible exchange rate policy

Vietnam is in a transition period in which it is getting access to the rest of the world that is still new to it. This forces Vietnam to be alert to changes in the world market conditions caused by the globalization. In such a situation, it's better to adopt a controlled flexible exchange rate system to generate development dynamic in the integration process.

To make such an exchange rate effective and produce positive results, it must meet the following requirements:

- It's necessary to determine a middle parity price between the VND and the dollar based on the multilateral real exchange rate (MRER).

- After finding the MRER, a band around it could be fixed. When the fluctuation in the rate is wider than the band, the central can take action after studying the inflation rates in Vietnam and foreign countries. In current conditions in Vietnam, I think that a narrow band of 3% on both sides of the rate could be appropriate.

- In implementing a flexible exchange rate policy, proper attention must be paid to the equilibrium rate of interest determined by money supply and demand for capital. Open market operation, discount window and required reserve ratio are instruments for regulating the money supply while the demand for capital changes according to the interest rate and economic growth. The interest rate on the VND is also affected by interest rate on foreign exchange and expectation of future exchange rate. These factors help the VND interest rate bring the exchange rate to equilibrium. This explains why the trading frame of the exchange rate is broken. Fluctuations in the exchange rate also help predict its short-term trends and expectation of the future exchange rate.

- All instruments for preventing exchange risk must be introduced to commercial banks. These instruments are useful in measuring expectation. In the integration process where trade liberation is a strong trend, the supply of and demand for foreign exchange are affected by capital inflows and outflows. The more diverse the instruments on the market, the more stable the money market.

- The effective exchange rate in a flexible system could provide conditions for making the VND convertible. Like other commodities, the convertible VND needs policies to create supply and demand forces. The trade balance requires balance not only in value but also in negotiable instrument. Weighted index in the MRER is an important factor in determining the volume of the Vietnamese đồng in international settlement.

In short, a controlled floating exchange rate that meet these requirements could help stabilize the foreign exchange market and support the integration process of Vietnamese monetary system into the world trade ■

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