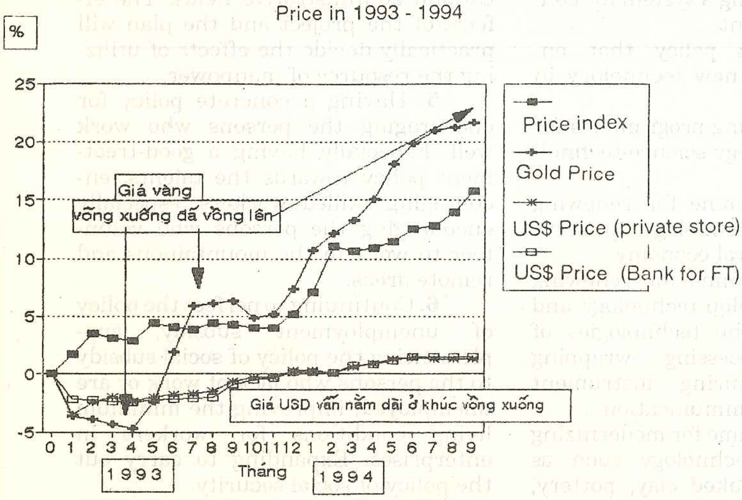
LEAVE EXCHANGE RATE TO INVISIBLE HAND OR CONTROL IT

by VŨ NGỌC NHUNG

The stability of the price of US$ after Oct 1, 1994 showed that the government was right when it ruled that Vietnam currency is unlimited legal tender. But if we want to stabilize the exchange rate, develop the economy and defeat the danger of falling behind, we can't be content with the present achievements and we should make a clearer and more effective policy on the exchange rate in order to keep the economy in developing.

Watching the fluctuation of the exchange rate in 1993 and 1994, we should be worried that the exchange rate didn't develop in accordance with the inflation rate. This can be seen in the following figure:

FIG.1



The inflation rate in 1993 was 5.2% but the exchange rate between the US$ and the VNĐ saw no change for 11 successive months, until December, the price of US$ made the first movement and it increased by 0.3% only in 1993 (equivalent to one-seventeenth of the price index). In 1994, the situation kept happening in this way: by September, the price index was 9.9% but the US$ lost only 1.1% of its value. Connectingthe two charts of price fluctuation as in Fig.1, we saw that in comparison with December 1992, price index is 15.8% whereas the US$ price is 1,3%.

The gold price curve sloped downward, in July 1993, and then upward to 21.7%.

This was the movement of the gold price connecting with the easily-inflated VNĐ under influence of the invisible hand, but the US$ price was kept low because of a voluntarist intervention in 1993. From March 1993 to February 1994, the State Bank took a 180-degree turn, from buying US$ at high price to fixing a closing price lower than the market price. With the thought of making the VNĐ rise against the US$, the State Banks sold US$ to importers at a price lower than the market price. Therefore in two centers of foreign exchange, the US$ demand always exceeded the supply. The State Bank has sold of hundred millions of dollars from the National Reserve Fund to fill this gap.

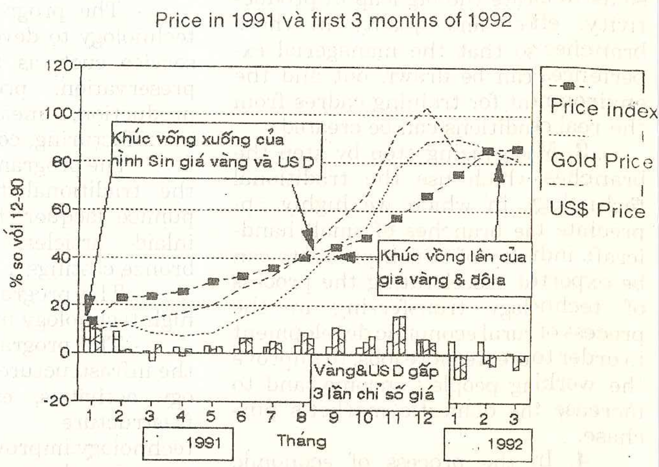
After many articles criticizing this importer-favoring measure, in February 1994, the Bank for Foreign Trade in the South bought the US$ at a price higher than the market price in only one month. From March to May 1994 its buying price was lower. From June 1994 on, the price of US$ was raised from VNĐ 10,972 to 10,992, an increase of 2.1%, it's higher than the market price.

I have spoken a lot of times of advantages and rationality of an act to devaluate VNĐ by degrees. My opinion is different from the others which wanted to devaluate the VNĐ strongly and raise the echange rate to 18,000 or 20,000 per US dollar, or which wanted to keep the VNĐ rising against the US$.

In short, there are three main opinions: (1) devaluating the VNĐ strongly, (2) devaluating it by degrees and (3) appreciating the VNĐ. The first opinion was spoken in support of exportation because developing exportation means expanding our foreign markets by making the best use of our comparative advantages. This opinion accorded with the law of money circulation because it connected the VNĐ inflation rate with the US$ depreciation. In many articles, I have said that changing the VNĐ-US$ official rate from a higher level to a lower one in comparison with the market price, as it happened in 1992, was a way of supporting importation instead of exportation. Therefore, our exports exceeded imports in the year 1992 only.

The way of fixing the US$ price at level which is sometimes lower, sometimes higher than the market price in the first half of 1994 and the way of keeping the price of US$ away from rising paralel with VNĐ inflation rate could cause a fever of US$ price in the near future. The logical basis for this worry is the law of money circulation which was first published by Karl Marx and was partly stated by the Fisher equation: MV = PQ; and its realistic basis was the fever of US$ and gold prices in 1991 as showed in the following chart:

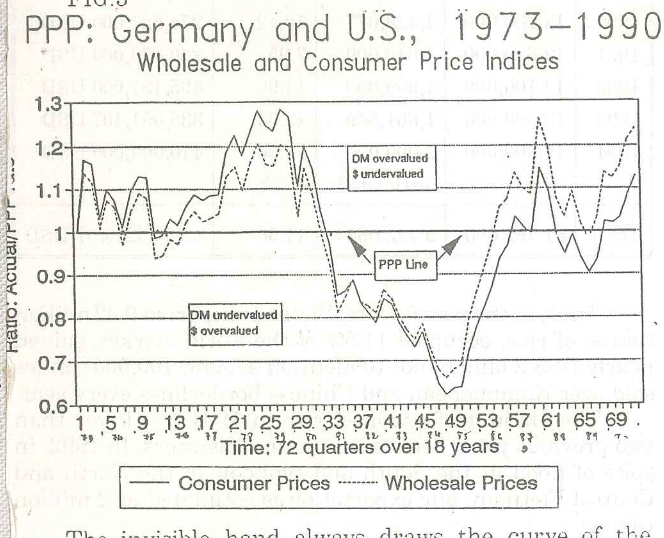
FIG.2



From Fig.2, we saw that in early 1991, the market price of gold increased by 8.5% only (equivalent to one quarter of price index growth - 30.2%), while the price of US$ increased by 19.8% (one half of the price index). By late 1991, the prices of US$ and gold made up for lost time and caused a threefold increase. They went according to the law of money circulation: the prices of US$ and gold should rise in direct ratio with the inflation rate of the VNĐ. The gold and US$ curves going along with the price index curve is a model of unsteadiness of gold and US$ prices in any country. The gold curve in 1993 sloped downward before July and went upward then (it reached 21.7% in comparison with December 1992) (see fig.1). The US$ curve has stayed low until now, and when will it go upward?

Obviously, this way of controlling the exchange rate is to leave it to the invisible hand of the market, it's contrary to the law of money cirulation. The concept of the nominal rate of exchange and the real rate of exchange has some points of similarity with Marx's idea of what the exchange rate is required by the law of money circulation. Permit me to repeat this idea: The external value of a currency (the exchange rate and gold price) should be appropriate to its internal value (depreciation rate). The real rate of exchange equals the nonimal rate of exchange minus the inflation rate. In a workshop organized in HCMC from March 14 to March 16,1994, Prof. Richard M.Levich from New York University presented many charts of the nominal rate of exchange. The following is one of them:

FIG.3



The invisible hand always draws the curve of the nominal rate of exchange in the surrounding area of the curve of the real exchange rate, and when it goes upward fiercely, violent shocks will occur such as recent devaluation of rouble or the yen-dollar exchange rate rising above 100 yen last year leaving bad effects on Japanese economy until now. Thus, we can see that, when inflation exists, the wavy curve says thay the exchange rate is unstable. In early 1991, without the State Bank's intervention, the invisible hand of the market kept the prices of US$ and gold low. At that time, instead of pushing the US$ and gold prices up in line with the inflation rate, the State Bank has left them to the invisible hand. This led to a fever of the US$ and gold prices by late 1991.

A flexible exchange rate policy means that we neither freeze the exchange rate nor leave it to the invisible hand. I support this idea and only want to say that we should do it according to the law of money circulation and give support to the exportation. In many workshops on the exchange rate, nobody protested this opinion. But the way of managing the exchange rate from July 1994 until now has given priority to the exportation and depended on the invisible hand as we can see in the following figure. This is what we should discuss.

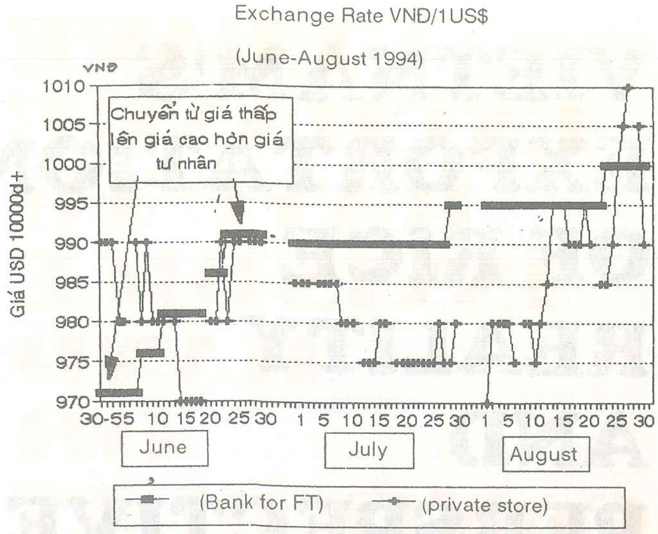


FIG 4

Small and frequent adjustments in the exchange rate in June in order to make it higher than the market price verifies the support given to exportation. Although the official rate inscreased by 2.7% from June to August, 1994, the market price only fluctuated a little and made no change from the price in May, 1994. In July 1994, the US$ curve was at the same level, I was told that the exchange rate at VNĐ 11,000 per US$ was fixed as a ceiling price.

If there was a fixed ceiling price, the flexibily was lost because of the following reasons:

- The rate VNĐ 11,000 per US$ isn't suitable to the situation in 1994, because a ceiling price of 11,500 was fixed in 1993. With a high inflation rate in 1994, a lowered ceiling price isn't suitable to the law of money cirrulation.

- The flexible exchange rate policy requires that the exchange rate can't be frozen at a certain number and it should be changed in proportion to the inflation rate, even it is changed around 10% only.

In 1991, the invisible hand kept the exchange rate unchanged for six first months and in the second half we had to suffer a fever of US$ price at VNĐ 14,000 before the State Bank intervened in December. In 1993 and 1994, the past repeats itself when the US$ price was much lower than the price index. So, the problems is we should control the exchange rate or leave it to the invisible hand. It's highly regrettable if we can't find a right answer before the US$ price increases by 21% or 22%, in line with the gold price depicted in Fig.1 ♣