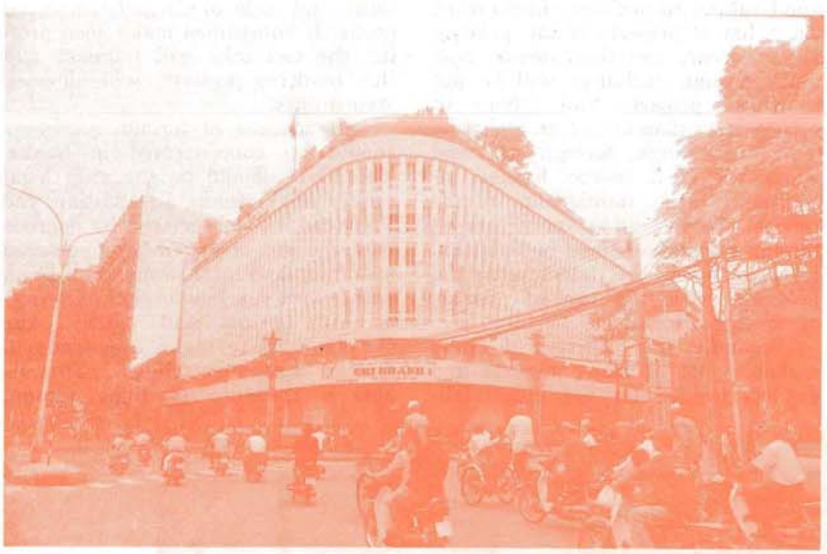

This confused the U.S. and forced it into initiating a devaluation of the dollar later. On the other hand, the U.S. inflation resulted in other countries' money supply and inflation when their central banks rushed to buy reserve currency to stabilize their exchange rate, at the same time increased their money supply in this period. The more the U.S. dollars were supplied, the higher inflation rates in the U.S. and other countries rose, this made foreign governments reluctantly accept this inflation growth via pegged exchange rate. The Bretton Woods' architects hoped the U.S.- its potential member - could have views wider and farther than its local targets and accept the policies for the world economic growth. Nevertheless, in fact the U.S. was not really concerned about that general

VIETNAM'S EXCHANGE RATE SYSTEM FACTS AND IMPLICATIONS

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1. Development of the international exchange rate systems

The exchange rate is a factor affecting greatly current accounts in the international balance of payments and other macro-economic variables, so it is one of important prices in the open economy. For the time being, industrialized countries are operating in a system in which their exchange rates are floating and regulated and their governments try to moderate exchange rate fluctuations and never peg them rigidly. However, this system was determined just from the beginning, but the history also witnessed striking changes in the exchange rate systems. From the World War II to 1973, the world economy had operated in the pegged exchange rate system in relation to U.S. dollar. This system was derived from the Bretton Woods Agreement requiring member countries to define their currency in terms of gold with only the U.S. pledging convertibility and the U.S. committed to hold the price of gold at US$35 per troy ounce. Consequently, the Bretton Woods system was based on pegged rates among all signatory countries. These countries maintained their international reserves by US$-valued assets such as American treasury bonds and short-term deposits with interest and these assets could be liquidated at low costs. In addition, it should be stressed that the members could sell U.S. dollars to the Federal Reserve System for gold. Under this system, all central banks fixed local currency against U.S. dollars via sales of local currency for U.S. dollar-valued assets in the foreign exchange markets. The country issuing currency which others kept as reserves played a special role because it never interfered in the foreign exchange markets and needed no funding to its balance of payments. In 1965 the U.S. escalated its military involvement in Vietnam. This was the time the tranquillity of the world monetary system no longer existed. The U.S. macroeconomic policies in this period were the key fault leading to the system breakdown. The U.S. military costs were increasing and its budget deficit compelled the Federal Reserve System to expand its monetary policies in 1967 and 1968. The U.S. inflation speeded up trends of speculation, gold prices fluctuated drastically and soared day after day. Therefore central banks in other countries required the U.S. to change their bonds into gold. goal. Since mid-1960 the Yank began rejecting this assignment, and since then the pegged exchange rate system has seen a break-up. A series of economic crises from the Spring 1971 triggered a rapid breakdown of both dollar and gold relations and stable exchange rates. By 1973 the pegged exchange rate system collapsed, the global inflation and floating exchange rate officially came into being.

From 1973 to 1980, the exchange rates had been fully floating, they were thus determined by the supply and demand relation in the market and not subject to any interventions. In this stage, floating exchange rates seemed to run smoothly, the international volatile balance of payments returned to equilibrium according to supply and demand relations. It is accepted that the floating of exchange rates enabled the central banks to control their money supply and determine their inflation rate. However, the observed facts indicated the floating exchange rate could not bring nations out of shocks caused by foreign monetary policies and money fluctuations in line with changes in the key currency - the U.S. dollar. The floating exchange rate system was doubtful. The central banks could not be indifferent to their currency value

in the foreign exchange markets and they continually interfered in these markets to adjust it. A mixed systems of floating and pegging took shape, and it was called controlled exchange rate system.

The controlled exchange rate also depends on supply and demand relations of foreign currency in the market. This kind is widely used in the world. But the intervention does not imply positive impacts at any point of time but it has also particular adverse effects. A central bank which is always in favor of fast economic growth will not allow revaluating its currency, and it will plan steady devaluations to make local products more competitive and boost export. The advantage of this practice is to generate good dynamics, fast economic growth, new jobs for workers and a fall in unemployment rate. But the inflation rate will certainly goes up and down sharply. In contrast, those central banks which are sensible to inflation issues and consider currency stabilization as a key target will tend to keep tightly their exchange rate and not let it move. This inevitably leads to low inflation rate, even deflation. When the money supply is tightened, the interest rate will jump, bank loans will become a burden to firms' production cost, business will be in doldrums, unemployment rises and finally the economy falls into recession. The industrialized countries' experience exhibits either overpegging or overfloating will cause serious consequences. As a result, a proper intervention is needed so that the price to pay is lower than the acquired goal. This depends on the central bank's intelligence and skill.

2. Progress of Vietnam's exchange rate system

In the 1955-1989 period, although many countries in the world were applying floating and pegged exchange rate systems while the nations in the socialist bloc performed central planning. Their governments ruled all aspects in the economy, so the floating exchange rate could not be allowed. Vietnam could not be an exception. The official exchange rate of Vietnam was announced on November 25, 1955 between Vietnamese *đồng* and Chinese yuan: 1 *đồng* = 1,470 yuans. This rate was determined by comparison of retail prices of 34 items of consumer goods between Hà Nội and some border provinces with the aim to settle the payment requirements between the two nations in the years of fighting against French invasion. Then the exchange rate between Vietnamese *đồng* and other currencies was set. In addition to the official rate (trade rate), the Government applied two more rates, that is non-trade and internal account rates. The exchange rate system of Vietnam in this stage was a multi-rate one. This system caused not a few challenges to the Government's financial management and at the same time left seriously adverse effects on the economy. Just because of this, the renewing of the exchange rate system in particular and the monetary policies on the whole is a pressing requirement.

After the National Party 6th Congress, the Government began renovating the economy, step by step abandoned its centrally-planned system and shifted to the market economy under the Government management. This is the time experiencing striking changes in the Government management concepts and economic policies, especially in the financial area. The exchange rate, a significant breakthrough in the renovation process, was paid special attention to. In March 1989 the Government officially abolished the internal account rate, and stopped all subsidies given to foreign trade activities. The official exchange rate was announced by the State Bank of Vietnam (SBV) in line with inflation rate, interest rate, and balance of payments with references to the free market exchange rates, and domestic and overseas gold prices. Based on this exchange rate, local commercial banks set their own rate for daily transactions within permitted range. These measures helped reform partly the exchange rate market, removed the irrational state in trade and payment, especially in import-export activities. However, the exchange rate remained drastically volatile, this can be documented by the following table:

THE EXCHANGE RATE BETWEEN U.S. DOLLAR AND VIETNAMESE *ĐỒNG*: 1989-1992

Year	January	March	June	September	December
1989					
Bank	3,500	4,200	4,350	4,100	4,200
Free market	5,200	5,350	4,400	4,225	4,575
1990					
Bank	4,300	4,300	4,800	5,750	6,650
Free market	4,650	4,450	5,600	6,300	7,050
1991					
Bank	7,000	7,400	8,300	10,700	12,900
Free market	7,400	7,900	8,830	11,050	12,550
1992					
Bank	11,880	11,550	11,285	10,950	10,720
Free market	12,200	11,550	11,290	10,980	10,650

These above data indicate drastical changes in the exchange rate between U.S. dollar and Vietnamese *đồng* since mid 1990 and see a peak in late 1991, then US$1 was equivalent to VND13,000. The main reason for the dollar appreciation was effects of the international balance of payments, budget deficit and high inflation rate in Vietnam. By late 1992, the inflows of foreign currency from Vietnamese expatriates increased sharply, in addition the SBV stabilized the exchange rate by intervening in the market, as a result, firms' demands for foreign currency was basically met and the inflation was curbed, this generated the public confidence in the local currency value and removed the trend of speculation. The appreciation trend of U.S. dollar was thus stopped, the exchange rate between U.S. dollar and Vietnamese *đồng* did not go up and even dropped.

In August 1994, the interbank foreign currency market was established. The SBV acted as final dealer in the day. It still announced the official exchange rate and changed the trading band. In 1996 the Vietnam's trade deficit amounted to US$4 billion, or 16% of the year's GDP, and 150% higher than those countries having biggest trade deficits. The demand for U.S. dollars soared and caused devaluation pressure on Vietnamese *đồng*. As a result, the State Bank had to expand the trading band of exchange rate from 0.5% previously to 1% and then 5% in February 1997, in addition the official rate was lifted steadily. From the early 1997, the exchange rate between U.S. dollar and Vietnamese *đồng* continuously increased, was not firm as in the 1993-1996 period. On July 27, 1997, the Asian monetary crisis sparked in Thailand. As a nation in the same region, the crisis has affected Vietnamese trade, payments and public mind. On Oct 13, 1997 the State Bank adjusted the exchange rate trading band to 10% against the official rate. Due to high demand for foreign currency in the market, commercial banks always sold dollar at the ceiling rate. Nevertheless, the U.S. dollar prices remained much higher, even rocketed to VND14,000/US$1, this resulted from the hoarding of U.S. dollars due to the fear that the local currency would be devaluated in the immediate future. Before this situation, the State Bank took a series of measures to secure the market such as regulations on exchange rate dealing. In particular, the State Bank adjusted the exchange rate two times: from VND11,175/US$1 to VND11,800/US$1 on Feb 16, 1998; and from VND11,888/US$1 to VND12,998/US$1, up 16.3% on August 7, 1998. In the meantime, the trading band was reduced to 7% from 10% as previously. The central bank's devaluation narrowed the gap in exchange rate between the free market and the commercial banks. In the late 1998, the rates of these two markets used to be equivalent.

In short:

The development process of the exchange rate systems exhibits the two basic systems as follows:

- Pegged exchange rate system: Those nations applying this system often base their currency on a key foreign one or a basket of foreign currencies (main currencies or Euro or special drawing rights - SDRs).
- Floating exchange rate system: In this system, the exchange rate is often flexibly adjusted. If it is determined by the market, it will be floating. If it is set in line with changes in such variables as reserves, payments, it will be controlled. Vietnam is applying the system of controlled exchange rate.

3. On the Vietnamese system of controlled exchange rate

Recently, the SBV has performed appropriate steps to control the exchange rate and attained certain achievements. However, in the condition of developing economy, effective market factors and expanding international relations such a system to control the exchange rate cannot yet be convincing. On Feb 25, 1999, the SBV issued two decisions on the exchange rate: Decision 64/1999/QĐ-NHNN7 concerning the exchange rate between Vietnamese *đồng* and other currencies and Decision 65/1999/QĐ-NHNN7 regulating the determination of exchange rates of credit institutions permitted to trade in foreign currency. From Feb 26, 1999 a new system to control the exchange rate was formed in Vietnam. Instead of announcing the official exchange rate, the SBV daily announces the average rate of the Vietnamese *đồng* against U.S. dollar in the interbank market. Based on this rate, the credit institutions' directors set their exchange rate not exceeding 0.1% of the SBV's rate announced on the previous day. They are also allowed to determine the exchange rate of other currencies. These two decisions have marked a new turning point in the exchange rate system in Vietnam. Their advantages may be distinctly seen as follows:

Firstly, the exchange rate daily announced by the State Bank is the average rate in the interbank market, this will make the exchange rate more objective and mirror the foreign currency supply and demand in the market. Although the former official exchange rate was based on the prices on the free market, the supply of and demand for foreign currency but it remained vague and subjective. We can see it when looking into changes in exchange rates of commercial banks:

- From Dec 1, 1997 to mid-February 1998, the SBV official exchange rate stayed at VND11,175/US$1, then the selling price of commercial banks was VND12,293 per dollar (11,175 x 110% = 12,292.5).
- On Feb 16, 1998 the SBV raised the rate to VND11,800/US$1, the selling price of commercial banks soared accordingly to VND12,980 (=11,800 x 110%) the next day.
- And similarly the price of U.S. dollar was calculated in the following days:

The year 1998	Feb 21	Feb 27	Feb 28	March 2	March 5	March 9
Official rate	11,803	11,804	11,801	11,799	11,798	11,803
Commercial banks' rate	12,983	12,984	12,981	12,979	12,978	12,983

The above table reveals the prices of commercial banks were always set at the ceiling price permitted by the SBV (official rate x 110%). The reason is easily understandable. Thus the existing exchange rate showed something sticky and not acceptable.

Once the price announced by the SBV is derived from the interbank foreign currency market, the commercial banks no longer feel anxious because this price is the intersection of the banks' foreign currency supply and demand.

Secondly, because the SBV's former official rate was announced stickily, not reflecting supply and demand relations, if the bank's price was low, enterprises would sell their money in the free market, in contrast if it was difficult to buy foreign currency from the banks, they would obtain it from the free market. As a result, just little changes in the economy could widen the price gap between the free market and the bank. But in the new system, the price set by the SBV is based on the foreign currency supply and demand between banks, so the gap between the free market and the bank will be narrowed.

Thirdly, in the former system, the SBV wanted to keep the price unchanged while the banks' supply of foreign currency was low, so the firms' demands were not satisfied. This caused troubles to firms when they hit due payments to foreign partners. The current exchange rate is redressed in line with supply and demand relations, in other words, the firms' demands are a ground for setting the exchange rate and at this rate there will be no imbalance between supply and demand.

Fourthly, once the exchange rate does not result from supply and demand relations, the SBV's adjustment of the exchange rate will generate a heavy mental pressure, especially when it is not amended regularly, the change will be a shock, leading to the public misunderstanding about the Government's policy; doubt of the local currency value and the speculating and hoarding of foreign currency. In the new system, to keep the exchange rate stable or adjust it in line with the particular target, the SBV make only sales or purchases of foreign currency because the price depends on the supply and demand relation.

Fifthly, in the new system, the exchange rate is derived from the market, it is more flexible and suitable to the international practices, contributing to the country's integration into the world economic community.

As mentioned above, the SBV's new exchange rate system not only overcomes shortcomings of the former system, but also keeps abreast of our country's open economy.

However, to make the system effective, we made some following suggestions:

Firstly, the SBV has to acquire enough foreign currency reserves.

This is the solution always attracting our attention. However, it has different implications in each stage. Previously, the exchange rate was fixed and announced by the SBV, it was of administrative measures, thus impacted the supply and demand relation more than this relation affected it. The relations could change, but the exchange rate remained constant (if the SBV saw it necessary). As a result, the central bank's foreign currency reserves were sometimes meager, but the nominal exchange rate kept unchanged.

In this new system, everything is not like it, when the market supply and demand change, then the rate will shift, if the SBV wants to keep it stable, it has to interfere. If the supply exceeds the demand, it is easy for the SBV to buy foreign currency by its Vietnamese *đồng* and increase its foreign currency reserves. In contrast, the demand surpasses the supply (this fact is more likely), the SBV must sell its reserves. Moreover, the SBV's reserves of foreign currency must be abundant enough to cope with speculative tricks in the market. The lessons from Thailand taught us that. Some foreign banks and financial institutions took advantages of an economic meltdown and defects of Thai banks to make speculations, triggering and aggravating the financial crisis. If the central bank reserves are not strong enough to interfere in the market if need be, it will return to administrative measures to keep the exchange rate or let it laisser-faire.

Secondly, well settling the relation between interest and exchange rates

The interest and exchange rates have close relations, if the exchange rate tends to go down, the interest rate will be paid more attention to, and vice versa. The behavior of selling-buying-depositing-withdrawing foreign currency are interactive and generating shifts between Vietnamese and foreign currency. Therefore, the interest and exchange rates should be paid equal attention to. The evidence suggests that in the early 1997, the exchange and interest rates progressed in the trend of changing Vietnamese *đồng* into U.S. dollar. In 1998, the 16% devaluation of *đồng* increased the gain from deposits in U.S. dollar rather than in *đồng*. This led to shifts from local currency to U.S. dollar and affected the disposable capital of commercial banks. The requirement for hoarding foreign currency generated false purchasing power in the market, stimulated the demand for foreign currency and speeded up the exchange rate. The banks hit a decline in purchase of foreign currency, even the SBV sold its foreign currency to keep the price.

Just because of this, the relation between interest and exchange rates must be paid concerns to. And a question arises: the exchange rate in the interbank foreign currency market can be the base to determine the foreign currency prices of commercial banks, then why cannot the interest rate in this market be the base to determine interest rates.

Thirdly, the exchange rate system must be perfected

The Government issued some documents regulating the exchange rate control such as Decree 63/1998/NĐ-CP on August 17, 1998; Decision 173/1998/QĐ-TTg on Sep 12, 1998. In general, these two legal documents reveal more liberal views. However, some remaining questions should be solved: immediate selling or keeping in the custody account? What is the percentage of U.S. dollars to be sold? In this article, we wish to make some necessary proposals:

- If the Government cannot yet assure firms to sell off their foreign currency to the bank, it should take more effective administrative measures. We do not mention how to sell U.S. dollars, we claim that the firms' accounts need a particular percentage of foreign currency they obtain. They can take their initiative in their little spending without submitting for approval, this will make them feel calm.
- The Government should pay attention to illegally traded sources of foreign currency, stop the bleeding of foreign currency, properly settle violations of the exchange rate system. These solutions encourage firms to comply with regulations on foreign exchange control.
- In any case, the legal demands for foreign currency shall be met.
- The Government should perform measures to intensify the foreign currency revenues.

In short:

The Government may launch various exchange rate systems in line with each period. Nevertheless, there are always fundamental factors for all periods, the Government should grasp these factors to make a comprehensive and appropriate policy. Only by doing so, can the Government effectively control foreign currency flows, attract foreign currency for its reserves, keep the exchange rate stable and perform the national monetary policy■