EXCHANGE RATE
A PROBLEM SHOULD BE TREATED WITH CAUTION

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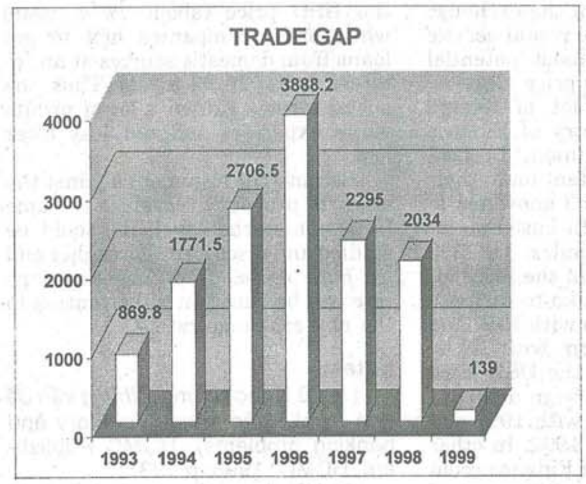
There is a division of opinion about the exchange rate in financial authorities with the result that the exchange rate didn't help with preventing the growth rate from falling as expected. Looking back at the exchange rate policy since 1991, we saw that it was regulated according to different views over time. In 1991, the exchange rate was allowed to float and in the first five months of the year, it rose by 19% (VND7,000 to the dollar) while the inflation rate reached 30.2%. At that time, we predicted the price of the dollar would rise faster than the price index (1) and the central bank should have bought the dollar to make the fall in the exchange rate equal to the rise in the price index and prevent the domestic currency from rising unreasonably against the dollar. The central bank wanted to keep the domestic currency from falling by more than 19% while its value had fallen by 30.2%. The consequence was a fever of the USD price: it rose by 204% (VND14,500 to the dollar) when the deposit rate was lowered from 4% to 3.5%. The unplanned devaluation that year, however, produced good effects on export and helped Vietnam gain a trade surplus in 1992 although there was no improvement in quality of exports or trading terms then.

When the Government intervened by selling over USD10 million (equal to one- third of the planned amount) the exchange rate rose to VND10,800 to the dollar. From that day to February 1993, the official rate was always fixed at somewhere from 1% to 5%(2) higher than the unofficial one with a view to encouraging the export business. From February 1992 on, however, the official rate was made lower than the unofficial one, that is, the banking authorities decided to give priority to the import business, instead of the export, and as a result the trade gap doubled year after year. Many experts in those years (1995-95) analysed disastrous consequences of the overvaluation of the domestic currency, at the end of 1995, the inflation rate made the domestic currency fall by 35% but the official rate tried to keep the devaluation at 2% only.

Until the conference of banking officials in June 1996, with the prediction that a monetary crisis could take place by the year's end, the SBV Governor petitioned the Politburo to allow the USD price to rise a little since October 1996. Therefore, Vietnam could stop the overvaluation of the domestic currency for nine months before the financial crisis broke out in Thailand and prevent it from spreading to Vietnam. After that, the trade gap decreased gradually as shown in the following figure.

Figure 1: Vietnam's Trade Gap (USD mil.)



At present, there are many arguments for the overvaluation of domestic currency:

1. The first argument identifies the rise in the USD price with devaluation of the domestic currency. This argument pays no attention to the real exchange rate and purchasing power parity (PPP) theory. The real exchange rate is the result of depreciation of a currency when inflation takes place. The stronger the inflation, the lower the real exchange rate. The relative PPP method expresses the real exchange rate in the following formula:

$$\text{Real exchange rate} = \text{Nominal exchange rate} \times \frac{\text{Local price index}}{\text{Foreign price index}}$$

This formula allows us to work out the real exchange rate of the VND, with 1992 as the base year (See next page).

Thus, the devaluation only takes place when the exchange rate exceeds the real exchange rate. At present, the nominal rate is VND14,050 to the dollar, lower than the real exchange rate of 14,826.7, that is, the domestic currency is still overvaluated. The situation isn't improved even if the exchange rate is VND14,500 to the dollar. At this rate, to say the currency is devaluated is like to lament a loss when the profit is reduced a little. The current exchange rate is usually lower than the market rate. This means that the banking authorities tend to sell the dollar at low prices in favor of importers. That is why prices of imported goods reduced by 5.4% and they flooded the domestic market. By devaluating their currencies by 5% - 15%, Asian countries, after the financial crisis, could recover faster than Vietnam who allowed its currency to rise by 5.4% only.

2. The second argument is a localist one that pays no attention to the national interests. In a meeting of PM Phan Văn Khải and business circle in the spring of 1998, many businesspersons suggested rising the exchange rate to encourage the export business. When dicussing other prob-

Year	Nominal exchange rate at year's end	Price index over previous year (%)		Price index compared with 1992 (%)		Real exchange rate compared with 1992
		Vietnam	U.S.	Vietnam	U.S.	
1992		117.5	103.1	117.50	103.10	10,800.0
1993	10,800.0	105.2	102.9	123.61	106.09	11,041.4
1994	11,041.4	114.4	102.5	141.41	108.74	12,323.3
1995	12,323.3	112.7	103.0	159.37	112.00	13,483.8
1996	13,483.8	104.5	102.9	166.54	115.25	13.693.5
1997	13,693.5	105.6	102.33	175.87	117.94	14,130.7
1998	14,039.1	109.2	101.61	192.05	119.84	15,185.6
1999	15,185.6	100.1	102.52	192.24	122.87	14,826.7

lems, many authorities have expressed their views on the exchange rate. For example, the postal service authorities worried about potential losses when the USD price rises because they owed a lot of foreign debts, and the Ministry of Finance shared the same opinion. In fact, they paid too much attention to their own interests and didn't know how to compare loss and profit based on increases in the price index. In 1998 for example, the rise in the price index allowed the tax take to increase by 9.8% in comparison with 1997 and 92.05% in comparison with 1992, while the increase in the USD price made repayment of foreign debt rise only by 7% compared with 1997 and 29.4% compared with 1992. In other words, the Ministry of Finance could gain profit from the difference of 2.8% (compared with 1992), or 62.6% (compared with 1992). The postal service secured foreign loans before 1996 at LIBOR rate plus a 1% rise in the USD price (about 7% a year) while other companies had to get loans from domestic sources at an interest rate of 25.2% a year. Thus, the postal service gained a lot of profits while exporters suffered loss after loss.

Because the argument against the effort to prevent overvaluation came from ministerial level, it should be studied and discussed thoroughly and we hope decisions on the exchange rate will be based on full attention to the real exchange rate.■

Notes:

(1) Vũ Ngọc Nhung, *Những vấn đề tiền tệ và ngân hàng* (Monetary and banking problems), HCMC Publishers, HCMC, 1998, p.123.

(2) Vũ Ngọc Nhung, ibid, p. 135 (the figure showing daily fluctuations of the USD price in the first three months of 1993)

In June 1998, PM Phan Văn Khải issued Decree 44/CP, as a replacement for Decree 28/CP, on changing state companies into joint stock companies (or equitization for short). This was a sign showing the Government's determination to reform the system of state companies – a major policy in the economic reform after 1988.

The most noteworthy in the decree was the permission to sell shares to foreign individuals and organizations. However, it took a year for the PM to issue Decision 145/1999/ QĐ-TTg on June 28, 1999 on the method of selling shares to foreign investors. And until recently, the Ministry of Finance issued Circular 132/1999 TT-BTC on Nov. 14, 1999 providing guidelines on this method.

Thus, besides the FDI, foreign capital in Vietnam, from now on, could take the FPI form (Foreign Portfolio Investment). If the FDI is hard to find and hard to be taken away, the FPI is much fluider, that is, foreign investors could put in and withdraw their money at any time they wish. Certain sensitive information could make foreign investors make important decisions, orders will be given and millions of dollars will be transferred from this country to another. The high fluidity of FPI could easily not only lead to wide fluctuations in stock prices but also upset the stock market.

To deal with this problem, all governments have set certain limits on flows of foreign capital, both FDI and FPI, in order to protect not only home industries but also foreign exchange and stock markets from troubles.

The said decree also set limit on the number of businesses done by equitized companies from which foreign investors could buy shares. The fact that the Decree 145/1999 allowed foreign investors to put money in 12 businesses engaging in ligh industry, road and water transport, and service industry showed that the Government was very cautious about opening the door to the FPI flow. This cautious approach, however, proved to be ineffective since 1996 when the banking authorities allowed foreign investors to become shareholders of joint stock commercial banks. Thus, the FDI and FPI could be found in the banking system -the backbone of the economy- and from which they could find their way to other industries. This situation makes efforts to limit the FPI to 12 businesses meaningless.