For More Perfect Futures Market Regulations

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Futures exchange is regulated by Decision 17/1998/QĐ-NHNN dated Jan. 10, 1998 made by the SBV Governor providing regulations on the trade in foreign exchange. In the past five years, regulations about maturities and premium have been adjusted many times. Current regulations are set by Decision 679/2002/QĐ-NHNN dated July 1, 2002, which stipulates: (1) maturity varies from seven to 180 days; and (2) premium varies according to four maturities: 0.5% for 7- 30 days, 1.2% for 31- 60 days, 1.5% for 61-90 days and 2.5% for 91-180 days.

1. Achievements and shortcomings

The birth of futures market helps reduce pressure on the spot market and provides investors with a new instrument for dealing with exchange rate risk. In the past few years, however, the futures market revealed certain sgortcomings. The following are some of them:

- Total sales are small and most of them have short matirities.

- Amount of futures sold is much bigger than the amount bought.

- Main traders are foreign banks.

The data show us main reasons for poor trade in futures:

+ The exchange rate on the spot market was so stable that customers don't feel a need to take precautions against risks. Sales of futures by commercial banks were very small. The stable exchange rate also persuades commercial banks to sell futures without buying some others because all predictions say that the exchange rate on the spot market would change very slightly. The exchange rate of the VND to the US dollar on the spot market rose by 4.58% in 2000; 3.92% in 2001; 2.13% in 2002 and 1.58% in 2003. This situation made the sale of futures profitable and all commercial banks never thought of buying futures.

+ Maturities didn't satisfy needs by customers: The maturity that varies from seven to 180 days isn't suitable to exporters and importers who need either shorter maturity (three days for example) or longer one (up to one year) because these maturities are more appropriate to their settlement, repayment of debts and precautions against risks.

+ Limitation set by the maximum and minimum

Table 1: Trade in futures in recent years

Year	Sales of futures/ spot sale (%)	Average futures sale per day (US$ mn.)	Future sale/purchase (times)
1999	3.67	1.6	1.56
2000	10.55	5.3	3.09
2001	5.98	3.7	4.06
2002	5.95	4.8	6.07
2003	5.14	5.8	4.79

Source: SBV

maturities: The maximum and minimum maturities (seven and 180 days) are applied to all transactions between foreign and domestic currencies. This regulation isn't suitable to international practices and become one of obstacle to the trade in futures.

+ Limit on the exchange rate ceiling isn't flexible enough and suitable to the floating exchange rate system:After its introduction, because the interest rate was still fixed by the SBV, the exchange rate ceiling for futures was applied differently to each maturity. From September 2001 on, the SBV allowed the existence of three or four maturities and the ceiling for each maturity was raised. This mechanism (1) allowed certain degree of autonomy in trading in futures for commercial banks; (2) limited to a certain extent the loss caused by changes in the exchange rate applied to futures (when the interest rate was floated, differences in interest rates in foreign currencies and domestic ones could make the exchange rate for futures to rise); and (3) encouraged competition between commercial banks for the sale of futures.

Although the current exchange rate ceiling is flexible enough to deal with sudden changes in the interest rate, the floated and changeable interest rate has really limited the trade in futures.

2. For better regulations on the trade in futures

Perfection of futures market regulations not only helps standardize an operation common on foreign markets, but also helps make the mechanism for controlling the exchange rate in Vietnam more appropriate to the international practices.

In fact, the exchange rate for futures is the exchange of interest rates between two currencies involved in the transaction. When the interest rate of the VND is liberated, the difference in the interest rate should be dealt with in relation with this liberation. However, there are two factors to deal with:

(1) The spot exchange rate is still determined by the exchange rate ceiling,

(2) Because the foreign exchange market in Vietnam is still in its first stage of development, asymetric information could distort reasonable expectations and thus producing unfavorable effects.

To solve those two problems requires time for the VND to become convertible and the foreign exchange market to become more professional. It is in such a situation that the trade in future becomes more important, because the exchange rate for futures will be the spot exchange rate in the future by which we can work out expectation of the market. Particularly, the introduction of a nominal exchange rate approaching a parity area that includes a parity center and a band around it is a must to the mechanism for regulating the exchange rate in Vietnam today. Preventing the reasonable expectations from being distorted by changes in the market is also a need. Another need is to use the regulatory mechanism for determining maturities expected by trading partners with a view to adjusting the mechanism for controlling the spot exchange rate.

There are three views on the perfection of regulations on the trade on futures:

- The first phylosophy maintains that the exchange rate for futures should be floated because there is no need for fixing it when we want to measure the market expectation. However, this argument is more suitable for developed markets where signs from the market are hardly distorted and its expectations could be measured reasonably. In Vietnam where the managed floating exchange rate system is adopted, the rate for futures couldn't be floated completely.

- The second view argues that the exchange rate could be floated with fixed rate applied to to 6-month and 12-month maturities. Those two limits constitutes a maturity ceiling with two maximum differences in the exchange rates α_6 and α_{12}. In reality, the SBV has adopted this mechanism but it includes four limits instead of two. The question is why these limits keep on existing when the interest rate is nearly liberated. If the answer to this wuestion isn't persuasive enough, the second view isn't practical.

- The third suggests removing all existing limits and expanding the range of maturities from 7-180 days to 3-365 days. But the more important task is to determine premium for each maturity. It's necessary to select righ interest rates when calculating differences in interest rates. One of solutions is to allow commercial banks to use asked and bid prices to work out premiums. But a more suitable measure is to adopt the Fed fund interest rate (for the dollar) and the base rate (for the VND). Although the difference in the interest rates between those two currencies is associated with their interest rates but it varies rather freely. This view opens prospects for option operation in the VND and exchange of non-dollar currencies.

Existence of different views is nornal but in our opinion, the third one seems optimal.■