Exchange Rate as a Policy to Support Economic and Corporate Growth

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1. Current exchange rate policy

The current policy pays too much attention to control over the nominal rate instead of regular analyses and estimates of the real exchange rate and its effects on inflation and export needed for timely adjustments to the official rate.

The exchange rate pegged to the dollar is basically stable (depreciation is not higher than 1% a year) while the inflation rate is high, which leads to complicated effects, such as:

- Companies tended to rely too much on a fixed exchange rate and make the best use of advantages of natural resources and cheap labor instead of replacing their technologies, increasing the added value of their products and services, preventing the exchange risk, and choosing suitable currencies used for payment made to foreign suppliers. That was why companies took strong reactions to slight rises in the domestic currency. On the other hand, ASEAN companies could deal easily with any rises in the price of domestic currencies against the dollar (from 20% to 25%) by improving their technologies, cutting the production cost, changing their target markets, selecting other paying currencies and employing risk-preventing derivatives.

- Due to a stable exchange rate (no exchange risk), investors could easily make the best use of differences in interest rates between loans in the domestic and foreign currencies; and between rates on the domestic and foreign markets to make speculations in currencies, which causes wide fluctuations in the market prices, made shortage and surplus of foreign exchange more unpredictable, and caused bad effects on implementation of the SBV monetary policy. When the tight-money policy is adopted, such an exchange rate can encourage commercial banks to use short-term loans from abroad, even from foreign banks, to finance imports. This situation causes more risks to the banking system (like the situation in Thailand before the 1997 financial crisis).

- Transactions between capital accounts are basically liberated except for some technical restrictions and limits on amount of shares held by foreign investors, which requires a flexible exchange rate and better coordination in implementing the SBV policy on the interest rate. The more flexible the exchange rate (wider bands on both sides of the rate), the more profound the effects of the SBV interest rates.

2. Some suggested adjustments to the exchange rate policy

a. Mechanism for regulating the exchange rate:

Decision to increase the band around the exchange rate is right, but the increases are very small and the implementation is slow, which is not appropriate to the liberation of transactions between capital accounts. So it's necessary to make the band wider in order to reduce the inflationary pressure and interventions by the SBV, and allow the market to adjust itself to changes in the supply and demand. At present, for example, when the trade gap is huge, the exchange rate tends to rise thereby reducing the trade gap; but narrow bands and SBV interventions in market forces reduce the effects of the invisible hand. And as a result, the trade gap may last for a longer time.

b. The exchange rate should be pegged to a basket of currencies instead of the dollar alone:

The basket used as a basis for the exchange rate may include from three to five most-traded currencies and each currency is given a weight based on its trading and investment relations with Vietnam. These weights and currencies can be adjusted to changes in investment and trading relations and kept confidential. Singapore has adopted such a policy with a basket of three currencies but said nothing about their names and weights.

c. The real effective exchange rate pegged to a basket of currencies must be analyzed intensively with a view to establishing the central parity used as a basis for regulating the exchange rate and setting the bands for specific periods. The central parity is what the nominal exchange rate must reach to allow the real exchange rate gains some equilibrium based on the same base year.

d. Interest rates offered by the SBV must be used as instruments for regulating the exchange rate besides purchase and sale of foreign exchange by the SBV. To achieve this aim, the SBV interest rates must reflect increases and decreases in the money supply. These decreases and increases, in their turn, depend on predictions of inflation. The SBV only sells or buys foreign exchange when the supply and demand are not in equilibrium at the central parity.

e. Other supporting policies:

- It's necessary to allow commercial banks (authorized to trade in foreign exchange) to buy and sell foreign exchange with all customers (as in a pilot scheme in Eximbank), thereby, along with expansion of the rate band, creating a continuous and overall market for foreign exchange closely linked with markets for forwards, futures and swaps. A foreign exchange market with various commodities and trading instruments can improve the equilibrium of demand and supply, limit speculations and enhance trust of the public in ability to get access to the market.

- The interest rate must be formed according to the principle that the market ensures structure of maturity and risk of the interest rate.

In the U.S. today deposit rate varies from 3.25% to 3.75% a year in major banks, and from 4.25% to 5.0% in smaller ones. This means that smaller banks always charge higher lending rates in comparison with major banks, and their customers are small and medium enterprises in their market segments. This is a key solution used for mobilizing deposits and ensuring lower risks for loans (because banks are professional credit suppliers), and prevent speculations in gold and imported raw materials that tended to make the trade deficit more serious. Moreover, effects of a market-based interest rate on the exchange rate will become more appropriate to the effort to reduce the money supply and curb the inflation.

- Stronger measures should be taken to supervise and control flows of short-term loans from foreign to local banks, or short-term bank loans with bank guarantee, and bonds in foreign exchange, including ones issued by the Government. Short-term loans tend to increase quickly when L/Cs are opened by importers with support by banks. These factors make supply and demand change suddenly and considerably causing a lot of difficulties for the task of regulating the exchange rate and interest rates on loans in domestic and foreign currencies as well.

- In the coming years, flows of foreign investment to Vietnam are estimated to keep increasing. When a floating exchange rate system is not adopted, the SBV has to keep buying foreign exchange to balance the supply and demand. This means that buying at high prices and selling at low ones are still pressures to the SBV capital. Besides measures that are still carried out, such as (1) setting a high required reserve ratio; (2) issuing SBV bills at market interest rate; and (3) adopting wider rate bands, other measures to be taken are as follows:

+ Depositing huge sums of foreign exchange (several billions of dollars) with major international banks as trustees at an agreed interest rate that is higher than the ordinary rate.

+ Establishing an international securities fund (likes ones formed in China and Saudi Arabia, or the US$300-billion Chinese fund) from reserved foreign exchange in order to generate income higher than the one from ordinary interest rate (This measure, however, requires experts in international investment).

- Control over capital inflow: For the time being, the stock exchange is in the doldrums, which makes the control over the capital inflow unnecessary. In the long run, however, studies of measures to control the capital inflow, especially in cases of urgency, are much needed. Some measures adopted by foreign authorities are: (1) a double exchange rate (a discriminatory measure against investments in securities); (2) Quantitative control (limiting sale of foreign exchange to investors in stock exchanges); (3) Reserve requirement for mutual fund; (4) Freezing the assets in depository for one year; and (5) Taxing the differences between interest rates, etc. However, such measures as taxes on transactions in foreign exchange for trade in securities; on income from trade in stocks and on differences between interest rates are the most effective. In Vietnam where stocks are traded through bank accounts, imposing and collecting such taxes become easier.

3. Advice for companies

Rises in the exchange rate give some advantages to exporters and help reduce the trade gap and inflationary pressure. In a shorter term, however, they cause some difficulties for companies, especially producers of exports, because they should pay more attention to the exchange risk when making decisions on new investments. To reduce risks, companies had better to cooperate with commercial banks to implement such derivatives as forward, futures and swap contracts. It's worth noting that fluctuations in the exchange rate are usually bigger than the ones in the interest rates, therefore reduction in risk-preventing costs in a short term is of great importance.

In the long run, companies should pay more attention to real economic effects of exchange of currencies and they had better develop strategies to manage the exchange risk along with strategies on marketing, production and financial management to cope with economic effects of changes in the exchange rate because such changes force them to change selling prices of their products and services, which affect their competitiveness. Corporate management should adjust the production plan and the use of marketing- mix in order to create new price relations thereby ensuring long-term profit. Companies can prevent the risks by relying on planned payables and receivables in foreign exchange, but risks caused by the competition arising from the competition against companies using other currencies – may last long and have far-reaching effects. They can not be quantified and solved easily by taking simple precautionary measures ■