A NEED TO REVIEW THE ROLE AND WAY OF IMPLEMENTING THE CURRENCY POLICY

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"Exchange rate is an important macroeconomic indicator that affects various fields of the economy. Until recently, however, the role of exchange rate and policy to regulate the exchange rate has seemed to be limited to the task of support the export and reduce the import. This unintentionally narrowed the role of the exchange rate."

The exchange rate is an important indicator of an economy, especially an open and highly integrated one as Vietnam's. Economic theories offer relatively clear concepts of exchange rate and ways of employing the currency policy, but in reality in Vietnam, attention is only paid to the role of exchange rate in promoting the export and limiting the import.

It is worth noting that the question of whether the exchange rate can really limit the import, thereby reducing the trade gap, receives no clear and persuasive answer.

In the past few years, many people were of the opinion that the exchange rate hindered the export growth and even became a barrier to Vietnam's exports, and therefore, they suggested devaluing the VND strongly to promote the export. In my opinion, however, this opinion only leads to effort to devalue the domestic currency without considering fully its impacts and meanings.

First of all, I do not think promoting the export in 2009-2010 and years to come at any price is a good solution because structure of Vietnam's exports is not favorable and they depend totally on changes in the world market in terms of trade terms and prices as well. At present, Vietnam only faces a small difficulty: the global crisis forces everybody to cut spending, which brings the export business to a slowdown. Another problem has also made its appearance: revival of the protectionism, even at a very high degree. Many countries will try their best to reduce imports to encourage consumption of domestic goods, considering it as the most effective measure to support local companies and reduce the unemployment. If the situation develops in this direction, the most important target for Vietnam in 2010, therefore, cannot be a high export growth, and the exchange rate should not be limited to export promotion.

If the exchange rate is oriented towards export promotion and import reduction, its role is narrowed despite its importance to the Vietnamese economy, especially such vital fields as balance of payments, settlement of foreign debts, monetary market, and price control, etc.

When Vietnam exports and imports in large quantities, or in other words, prices on the domestic market depend heavily on the ones on the world market, the currency policy has a great impact and in various manners on the average level of price on the domestic market. This shows itself in the years 2007-2009 when fluctuations in prices of any line of goods or services in the world market always produced the same fluctuations in the domestic market. Watching the direct relation between the CPI and the exchange rate to the dollar in the years 1995-2010, we see that the CPI always increased in parallel with the exchange rate

In another aspect, the exchange rate influences the settlement of foreign debt. Generally, devaluation

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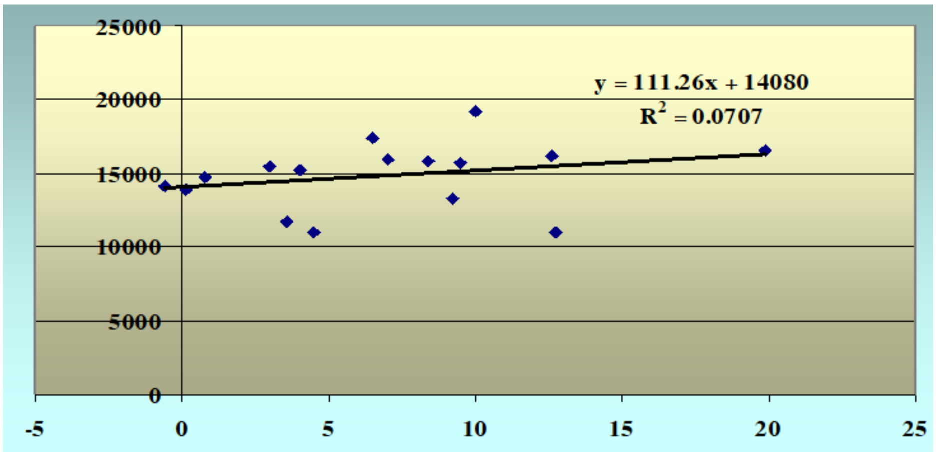
Figure 1: Relation between CPI and exchange rate to the dollar

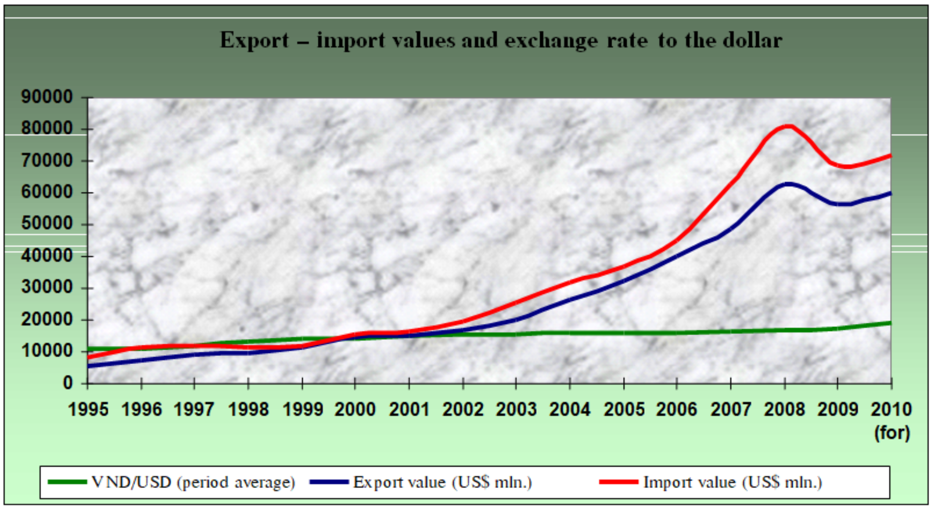


of the domestic currency is considered as a measure to promote the export but it also makes the foreign debt expressed in the VND much heavier and affects badly the ability to repay old debts or borrow new ones. Vietnam's foreign debt has amounted to 30.5% of its GDP while the government debt (in the VND and foreign exchange as well) equaled 40% of the GDP by the end of 2009.

in foreign trade and investment in Vietnam in 1995-2000 show that total export value, total import value, and total registered and realized FDI seemed to have no relation with adjustments to the exchange rate althout the realized FDI was directly proportional to changes in the exchange rate to the dollar.

At present, the Vietnam's exchange rate is still pegged to the dollar. In other words, the exchange

Figure 2: Export-import values and exchange rate to the dollar



In my opinion, it is about time Vietnam re-estimated the role and impacts of the exchange rate and currency policy on the economy. It is necessary to put the exchange rate in relations with export, import, investment, national debt, and monetary policy, etc. and in the general strategy that aims at enhancing convertibility of the VND. At present, few countries use the VND in exchange and settlement. Changes

rate to the dollar is most widely recognized and used. Rates to other currencies, including the EUR and JPY, are basically based on the rate to the dollar. Financial authorities have considered using a basket of currencies to work out the exchange rate but the idea is never put into practice.

The Government has decided to adopt a flexible exchange rate under the state control. The

Figure 3: Changes in FDI and exchange rate to the dollar

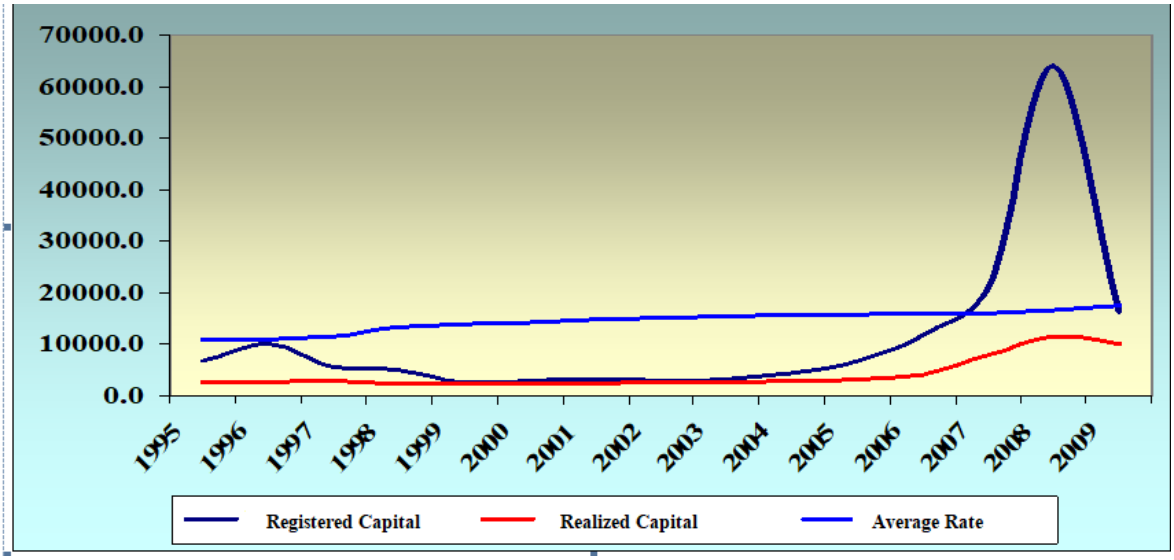
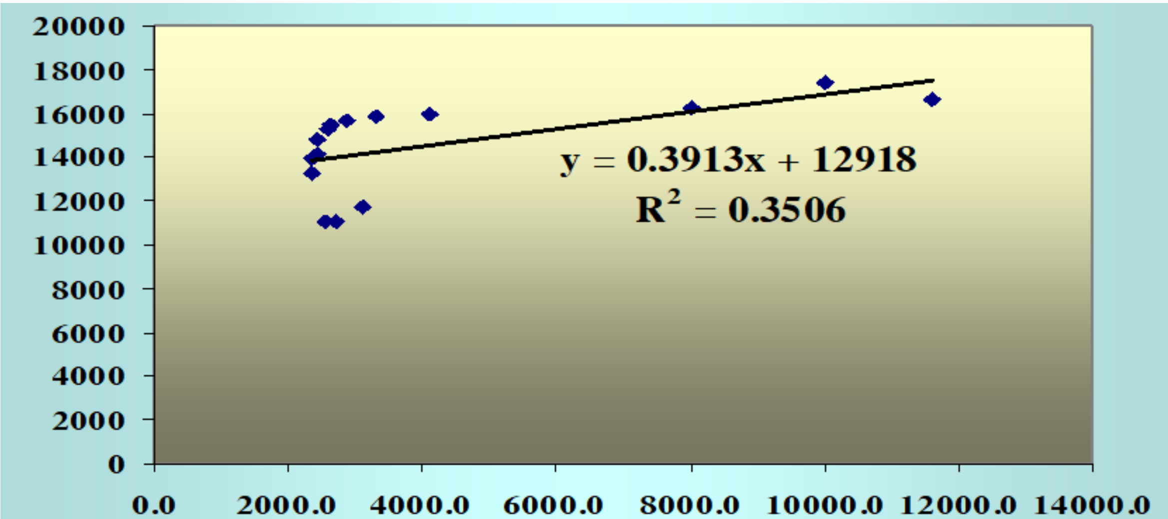


Figure 4: FDI disbursement and exchange rate to the dollar



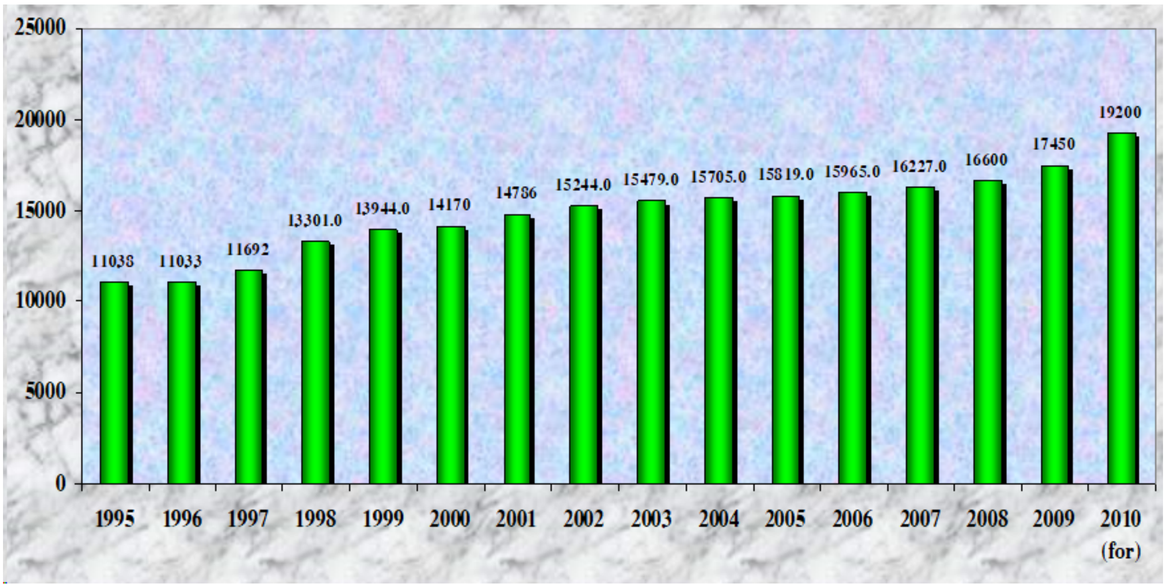
SBV also affirmed that the exchange rate was based on the inter-bank rate, the real rate of one day was used as the publicized rate for the next day, and financial institutions could apply this rate with a band on either side of the rate (this band is ±3% now).

When the exchange rate experiences shocks (a high hike in the unofficial rate for example), the SBV can adjust the band. For example, it expands the band when it wants to keep a balance between supply and demand.

Keeping track of changes in the exchange rate from the early 1990s up till now, we saw that the VND has been devalued by degrees, that is, the exchange rate was raised gradually. If Vietnam wants to promote its export, the more the devaluation of its currency the better. But depreciation may cause the price level in the domestic market to rise and lead to inflation, not to mention uncertainty about export growth.

In the world, there have been cases of deep and sudden devaluation such as China with its devaluation of 20% - 30% in the 1980s. As for Vietnam, I support a gradual devaluation, including cases needed for promoting the export or stabilizing the economy. Such a shock measure may produce an important turning point. However, reaction of authorities, the economy and the public to these

Figure 5: Average rate to the dollar in 1995-2010



"shocks" without necessary experience, may cause bad consequences.

To answer the question concerning the direction for the exchange rate, I want to stress again that we should review its role in export promotion and other fields, such as market price, inflation, and the health of the finance market and the finance sector as well. Only after affirming these roles can we discuss a currency policy, devaluation or revaluation of the VND, and work out appropriate ways to implement effectively such a policy.

Over time, the official rate sometimes equals the unofficial one; and there may be huge differences between these rates because the free market is more sensitive to changes in market forces, especially when it is affected by rumors.

Story of the free market also has a lot to do with the currency policy. In the past few years, implementation of this policy was not flexible enough and less responsive to changes in the market forces. Of course, slow reaction may help ensure macroeconomic stability but it may lead to widening differences between supply and demand, between components of the market and create loopholes that gives birth to malicious rumors and speculation.

In Vietnam today, to the best of my knowledge, the banking system and official financial institutions control some 90% of the forex market and the free market 10%. Although the latter is like the tip of the iceberg, it can reflect in a relatively exact manner changes in the whole market in action. When the official market fails to response timely to upheavals, the public tend to do business in the free market. At present, Vietnam has to accept the existence of a free market for foreign exchange. In fact, many countries do not allow free trade in foreign currencies and their laws demand that the domestic currency is the only legal tender, and this demand is observed by the public, organizations and governmental bodies of all levels. Handling of differences in interest rates for loans in the VND and foreign currencies within the financial sector and exchange of domestic and foreign currencies on the finance market also pose a lot of problems when Vietnam tries to liberate the capital account.

In summary, the review of the role and way of implementing the currency policy in the coming years should be based on the following principles and orientation.

(1) The band around the official rate, or differences between the official rate and the ones offered by commercial banks, can be narrowed. The official rate should be adjusted flexibly based on signals from the market and targets set by the SBV for the monetary policy.

(2) Adjusting the official rate cannot be done by devaluing the domestic currency by degrees. It can be revaluated as required by the forex market at times. The SBV sometimes has to adjust the rate strongly in a short period of time to make the exchange rate an effective instrument for developing trade and investment, and/or intervening into the finance market according to targets set for each period and programs to restructure the economy in general or foreign trade and investment in particular.

(3) The currency policy must be associated with other macroeconomic policies, such as the ones on exchange control, trading, investment, and macroeconomic stability, especially policies to control deficit in balance of trade, balance of payments, balance of payments on current account and national budget; policies to control the inflation, credit growth, interest rate, foreign debt, budget expenditure and income in foreign exchange, and forex reserve, etc.

(4) The financial system should enhance its competence to satisfy diverse and legitimate demand for foreign exchange in terms of access to sources of supply and exchange rate. Authorities should take measures to control the unofficial trade in foreign exchange, orient it towards the official market, and in the long run, put the free forex market to an end.

(5) Authorities had better work out a program to change all transactions in foreign exchange to trade in derivatives from the forex market, thereby limiting and ending bank deposits and loans in foreign exchange. This effort aims at making the VND the sole legal tender in the Vietnamese territory, reducing the widespread dollarization, and putting an end to distortions in the monetary market and banking system caused by differences in interest rates on loans in the VND and foreign currencies. In addition, there must be laws on circulation of foreign currencies, and a mechanism for controlling and using sources of foreign exchange■

References

1. IMF, Vietnam Country Reports from 1995 to 2009.
2. GSO, Statictical yearbooks from 1995 to 2009.