ON THE EXCHANGE RATE SYSTEM IN VIETNAM

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In the market economy, international trade becomes widespread, payments made between two or more countries should be based one currency or another. To exchange one currency for one unit of another currency, an exchange rate is set. The exchange rate is the price of one currency expressed in terms of another. There are two way of making price quotation of a currency: direct quotation and indirect quotation. In the direct quotation, the exchange rate and value of the domestic currenry move in opposite directions, and in the indirect quotation, they move in the same direction.

The exchange rate is considered as a regulating instrument used by governments for regulating the trade balance on order to obtain their planned targets, because the exchange rate affects greatly the import and export of goods and capital, and prices in the domestic market, that is, it produces great effects on the national economy. When the exchange rate falls, there is depreciation of the domestic currency, exports become cheaper, their competitiveness is enhanced and export business develops. The fall in exchange rate also makes imports dearer and thus reducing import. On the contrary, a rise in exchange rate discourages export and promotes import.

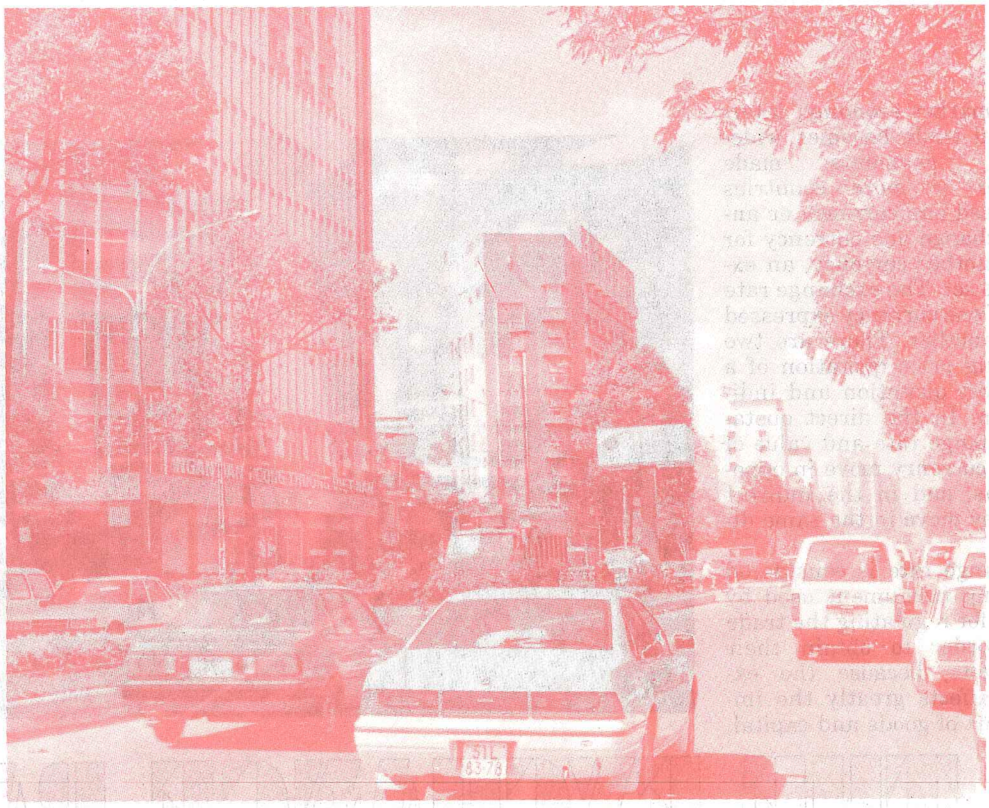
Changes in exchange rate could affect the flow of capital between countries. The capital movements aim at looking for profit and avoiding risk. When the exchange rate falls and there is a prediction that it will stop falling, the capital inflow will increase while the capital outflow decreases. When the exchange rate rises and shows sign of stooping, the capital outflow will increase and the capital inflow decrease.

Prices in a country are affected by the exchange rate besides other factors. When the exchange rate falls, prices of imported capital and consumer goods will rise and make prices of local goods relating to imports increase accordingly. The demand for imports will be bigger when the fall in exchange rate reduce the import, and thus making the market prices rise. On the contrary, a rise in the exchange rate will reduce prices in the domestic market.

Those effects caused by the exchange rate make all governments want to control it with a view to achieving their planned targets.

In the past, however, when Vietnam adopted the centrally-planned economy, the effects of the exchange rate were reduced to the minimum and it almost produced no effect. The international trading was carried out by state-owned companies according to plans set by the State. Operation of these companies didn't aim at making profit but at realizing the plans assigned by the government. Their profit, if any, is transferred to the treasury who gives them subsidies if they suffer losses. In such conditions, the exchange rate has no effect on the foreign trade. In certain cases, companies had to export goods even if their prices were falling because the export plan had been made. The same thing also happened to importers when prices of imports rose. In addition, the exchange rate played almost no role in regulating the capital movements. There was no capital inflow however low the exchange rate was because the domestic currency wasn't convertible. Generally, the market prices under the centrally-planned economy were fixed by plans instead of by market forces, therefore the exchange rate had no effect on the market prices.

For a long time, the exchange rate of the Vietnamese currency was kept very high. It failed to reflect not only the supply and demand forces in the foreign exchange market, but also the value of the domestic currency. We could say that the exchange rate at that time was only a coeeficient used by state-owned import and export companies for making business plans and working out their profits and losses. All of them put the economy at a serious crisis



for years when there were two exchange rates: a high official rate set by the government and a market rate determined by the supply and demand forces.

However, in the economic reform aiming at replacing the centrally-planned economy with the market economy, new mechanisms have been established and developed. To adjust to the market economy, the government should make the best use of effects of the exchange rate on export and import businesses.

The problem now is what system of exchange rate to choose: fixed, floating or controlled floating exchange rate. Many discussions about this matter have taken place. Many countries have changed from the fixed exchange rate system which was applied from 1945 to 1973, to the floating exchange rate system. In the late 1980s, however, this system revealed bad effects on the economy and many people started to think of a controlled floating exchange rate system that could limit these bad effects.

At present, all governments want to make intervention in order to limit fluctuations in the exchange rate instead of letting it float. Without government intervention, fluctuations in the exchange rate, on the one hand, are necessary to redress the balance between supply and demand quickly, but on the other hand, they could cause unwelcome changes in prices and output in the domestic market.

As for Vietnam, when the completely free trade hasn't come into being, it couldn't apply the floating exchange rate because of the following reasons:

(1) The local supply isn't great enough to increase quickly the export and reduce remarkably the import when adopting the floating exchange rate system, thus Vietnam can't depend on this system for a more favorable balance of payments. On the contrary, the floating exchange rate system may upset the trading business, induce speculation, and produce bad effects on the economy as a whole.

(2) The market economy in Vietnam hasn't developed well enough to adopt a floating exchange rate system. The finance market has just come into being, the stock market hasn't been formed, therefore there is no precondition in Vietnam for freely trading in commodities and capital based on a floating exchange rate system.

These conditions show that Vietnam had better adopt the controlled floating exchange rate system. This system offers many advantages: (1) it could reflect timely changes in supply and demand forces, that is, it isn't as unrealistic as the fixed exchange rate system, (2) government interventions could help prevent unwelcome fluctuations in the exchange rate from causing damage to the economy, and (3) it makes it easy for managers to work out their business strategies because they could somehow predict changes in prices instead of struggling permanently against fluctuations in exchange rates.

With this viewpoint, the Vietnamese government adopted the controlled floating exchange rate system in 1989 and constantly tried to adjust the official rate to the unofficial one. By mid-1991, two rates were unified to a certain extent. The daily rate quotation made by the central bank is based on the closing prices in the inter-bank foreign exchange market on the previous day.

This exchange rate system has produced certain good results: promoting the export, stabilizing the foreign exchange market, and allowing smooth economic development in spite of serious effects of the Asian financial crisis in the past few years. Recently, the government has gradually lowered the exchange rate to promote the export, improve the balance of payments and reduce the trade gap. In 1999, the trade gap was US$400 million, the lowest level ever seen. In the first months of 2000, the export value shows an upward tendency; it is estimated at US$900 million in the first quarter of 2000, increasing by 19% as compared with the same period last year, two time higher than the target set for the year. The trade gap in the first quarter is about 5.5%, much lower than the trade gap in previous years. These results allow us to believe in a brighter future■