Measures to control the exchange rate in Vietnam

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We are paying the penalty for the poor control over the exchange rate in the past few years: thin foreign exchange market, heavy pressure on the foreign exchange reserve, poor competitiveness of local goods because of highly-valued Vietnamese đồng and SBV failure to implement the monetary policy in the international integration process.

The exchange rate in Vietnam is a sensitive matter that affects the structure of industry and many social problems. Control over the exchange rate is also a controversy. Many experts suggest a strong devaluation of the domestic currency – as high as 30% if need be – to improve the competitiveness of local goods on the world market. They maintain that the effective real exchange rate of the VND is too high. Some economists, however, think that the devaluation could erode investors' trust in the Vietnamese business climate and turn external debt into heavy burden to the national budget. They suggest a wider band for the exchange rate as a feasible alternative. Meanwhile, the representative of IMF in Vietnam has suggested revising data that proved the effective real exchange of the VND high because this conclusion depended a lot on various statistics and opinions of experts who produced these data. In addition, the real exchange rate is only a fact to refer to, not the only or the most important factor in the implementation of the exchange control. The IMF representative only said that the exchange rate of the VND should be more flexible. The SBV, however, kept on taking a cautious attitude and only increased the band around the exchange rate from 0.1% to 0.2% under the pressure of public opinion.

To provide another view of the problem, we suggest here some measures to control the exchange rate in its relations with foreign exchange reserve, balance of payments deficit, and monetary and fiscal policies.

1. Foreign exchange reserve and exchange rate system

Traditional viewpoint on the foreign exchange reserve pays full attention to the balance of current account. According to the WB, the reserve must big enough to cover the import value of a period from three to six months. The latest IMF estimate predicted the Vietnamese foreign exchange reserve reached US$ 3.9 billion in 2002 and would rise to its peak of US$6.3 billion by 2006 equaling the value of imports in a period of two months and a half. Thus the foreign exchange reserve is low by international standard. Greenspan and Guidotti in their Currency Reserves and Debt (1999) suggest that the reserve must be at least equal to the volume of foreign capital that would be withdrawn during a year.

The foreign exchange reserve must be big enough to repay external debts when due and balance of payments deficit. Studies by Bussiere and Mulder (1999) proved that the Greenspan – Guidotti rule was helpful in preventing the crisis when the balance of current account surplus equals 2% of the GDP. When there is no surplus in the current account, however, the reserve needed for dealing with possible crisis must be twice higher than the volume of short-term external debt. If a nation suffers balance of current account deficit, the reserve must be much higher, varying from 10% to 20% of the GDP in many cases. In the years 2002-06, the Vietnamese foreign exchange reserve and balance of payments would be somewhere between those two states because (1) the reserve is much higher than the external debt due to government's strict control over borrowings by both public and private sectors, and (2) the deficit in the balance of current account varies between 1% and 3% and requires a big reserve. The foreign exchange reserve of Vietnam is very small but foreign experience show that strict control over short-term foreign capital and a flexible exchange rate could help prevent the financial crisis.

Traditional economics maintain that the wider the deficit in the balance of payments the bigger the national reserves. Many case studies have considered past fluctuations in the foreign exchange reserves as typical of changes in the balance of payments. Figure 1 shows rates (right side) and standard error (left side) of the ratio of the foreign exchange re-

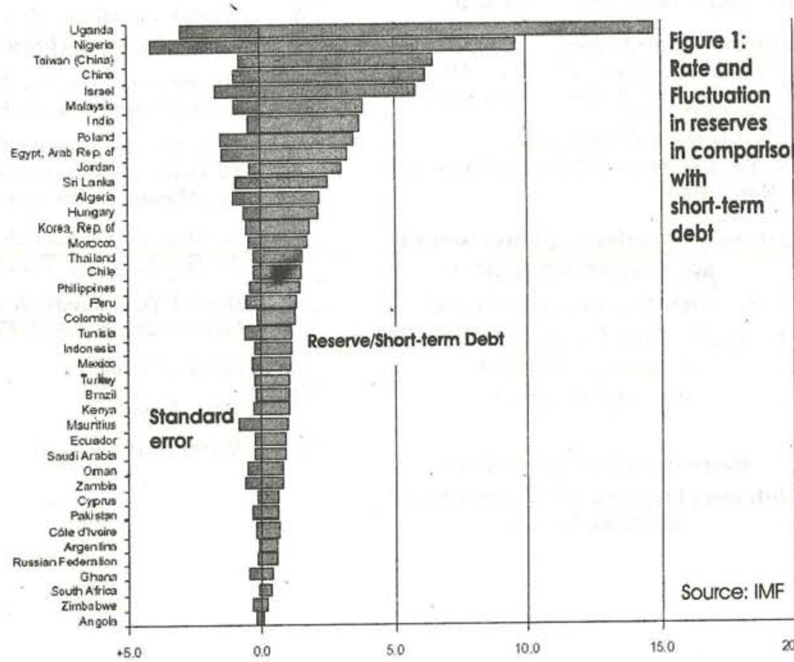
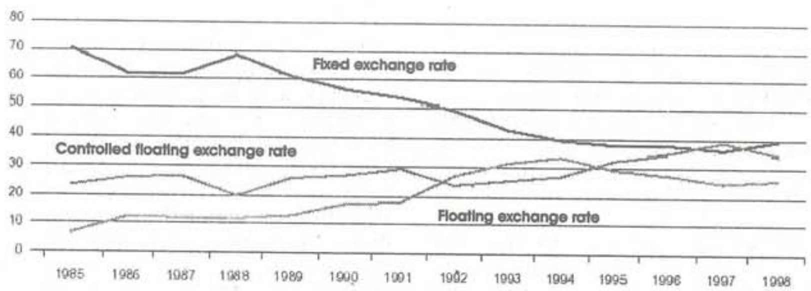


Figure 1: Rate and Fluctuation in reserves in comparison with short-term debt

Source: IMF

serve to short-term external debt in 20 countries. IMF studies show that the correlation coefficient of those two variables is 0.85. This means that the fixed exchange rate system needs a bigger reserve than what the floating exchange rate system requires. That is why more and more countries have adopted a flexible exchange rate system with a view to reducing pressure on the national reserves (Figure 2)

Figure 2: Changes in the exchange rate system adopted by countries



Source: IMF

2. Monetary-fiscal policy and exchange rate

Facing the above-mentioned trend, Vietnam has to decide what exchange rate system to adopt, but first of all, we had better study current trends in other countries. IMF studies show that most countries want a flexible but well controlled exchange rate. Many central banks maintain a nominal or crawling peg exchange rate system that reflects a tendency towards a tight money policy or economic independence. However, as Frenkel and Mussa pointed out, a flexible or floating exchange rate system is not enough to assure an independent monetary policy because of wide and constant fluctuations in the exchange rate associated with the globalization. Therefore, many countries prefer an exchange rate system that lies somewhere between an incomplete floating exchange rate and a crawling peg one. Such an exchange rate, however, has its own problems. One of which is the demand for a big national reserve needed for protecting official parity values.

These analyses encourage us to suggest that the SBV, for the time being, should adopt a flexible exchange rate with a crawling band that varies according to basic economic indexes of Vietnam with two problems to consider:

Firstly, the width of the band must be determined. This width depends on how independent the monetary policy is. The wider the band, the more independent the monetary policy. In its turn, the usefulness of the independent monetary policy in limiting fluctuations in the exchange rate depends on other regulatory instruments such as a flexible fiscal policy, and origin of sudden changes in market conditions. At present, the government must give full rein to the SBV in order to help it implement a flexible monetary policy. The current fiscal policy is too strict. It forces financial authorities to keep budget deficit under 3% of the GDP while only five out of 56 cities and provinces make regular payments to the Treasury. Foreign experience shows that when the fiscal policy isn't flexible enough, the only solution is to make the monetary policy more flexible by adopting a wider band around the exchange rate. Studying the monetary policies of such developing countries as Israel, Columbia, Chile, Indonesia and Malaysia, we saw that the band around the VND exchange rate could be 7% or higher. In urgent cases, the government could intervene directly in the fixing of the band using national reserves to produce effects on the foreign exchange market, or indirectly by making adjustments to interest rate, taxation and other regulatory instruments. In my opinion, the SBV had better pay attention to the following aspects when fixing the band around the exchange rate:

- The Vietnamese đồng could be pegged at a weighted average of a basket of currencies including the dollar, euro and yen, instead of the dollar only.

- The band must be based on the weighted average of a basket of currencies. This means that the SBV doesn't intervene in the exchange rate when the exchange rate of the VND to the dollar exceeds the 7% band but the rate to the euro and yen doesn't.

- Only SBV leadership is informed of the real band so they can regulate the exchange rate more flexibly in each period.

Secondly, the middle parity price must be based on the long-term real exchange rate. Experience from many developing countries shows that the fixing of middle parity price aims at maintaining high competitiveness of local goods on the world market. The middle parity price must be based on the long-term real exchange rate in order to prevent individual rearrangement of market forces. Facing low foreign exchange reserve and constant balance of payments deficit, the parity price set by exchange control authorities must be based on not only differences in foreign and domestic inflation rates but also changes in equilibrium of real exchange rate caused by fluctuations in market conditions, such as changes in export and import, implementation of AFTA and BTA, budget deficit and effects from foreign financial markets. Recent studies by IMF made out a case for this argument when reporting that such neighboring countries as Indonesia, Malaysia, the Philippines, Singapore and Thailand have followed closely the equilibrium of real exchange rate when capital inflows were high.

In short, we support a controlled flexible exchange rate system or something like that. In the long run, the SBV had better pursue an exchange rate system that is controllable and flexible enough. Of course, the flexibility is very different from inconsistency in exchange control that is harmful to international trade and integration because it involves high degree of risk and makes the economy more vulnerable to sudden changes. Foreign experience also shows that a controlled floating exchange rate system involves a basic weakness because it's difficult to determine how and to what extent it could be controlled. Vested interests could suggest a conservative approach to the exchange control with a view to avoid all possible risks, especially to their position. Such an approach has led to a thin market for foreign exchange in Vietnam with the result that Vietnam met with great difficulties in integrating successfully into the world economy ■

Reference

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- *World Bank Global Development Finance 2000*
- Pablo Guidotti & Alan Greenspan, *Currency Reserves and Debt*, 1999.