



Exchange Rate Policy in the International Integration

by MEcon. PHAN NỮ THANH THỦY

In the process of international integration, the banking and monetary sector should be prepared for foreign competition. To integrate the banking and monetary sector means liberating gradually this sector, including the exchange rate. The liberation of the exchange rate means letting it be determined by market forces and limiting direct intervention of the government and the central bank. However, they can affect the exchange rate by using indirect instruments. To be more precise, the liberation of the exchange rate can be carried out according to the following process:

- Increasing, and then removing, the band on both sides of the exchange rate.
- Stopping setting and publicizing the official rate.
- Letting the exchange rate be determined by the market forces and the central bank affects it indirectly if need be.

The liberation of the exchange rate produces great effects on foreign trade, value of the domestic currency, inflation rate and other transactions. It is associated with acts of loosening and then removing exchange control and all

limits on current transactions and flows of capital. This is usually the stage following the liberation.

1. Exchange control in Vietnam

After the economic reform was launched, the Government took measures to reform the foreign trade and exchange control in order to remove monopoly in foreign trade and allow all companies to import and export what they want. The exchange rate system also experienced basic changes. A flexible exchange rate under the State control was adopted and the implementation of this policy varies over time. These changes could be divided into three periods:

- 1993-96: The SBV set forth the official rate and the band, and introduced many exchange control rules. Some of these rules were as follows:

- + The official rate and the band were publicized everyday.
- + Concerns that earned foreign exchange were forced to sell it to the SBV according to the official rate.
- + The SBV also publicized other indicators, such as market rate, price index, gold price, etc.

The official and market rates in this period were not much different. Growth of the exchange rate was smaller than that of the inflation rate because it was affected by the demand and supply forces along with other external factors.

The stability of the exchange rate for many years helped beef up the purchasing power of the domestic currency, curb the inflation rate, increase the flow of foreign exchange to banks and encourage foreign investment. This effort, however, discouraged export, which made the foreign trade less busy.

In this period, the inflation rate rose by 36.8% while the exchange rate increased by only 2% with the result that exports flooded the domestic market and Vietnam suffered a huge trade gap.

- 1997- Feb. 25, 1999: The SBV kept publicizing the official rate and the band, and adjusted them continuously to the market rate.

In this period, the demand for exchange rate was always greater than the supply and the inter-bank foreign exchange market was in the doldrums at times. The Asian financial crisis affected unfavorably the public mentality and made the market rate rise strongly. To regulate the supply-demand relation, the SBV increased the band from 1% to 5% and then, to 10%, which helped reduce the demand for foreign exchange.

In 1998, the exchange rate experienced complicated changes. Daily increases in the price of the dollar caused negative effects on the socioeconomic life. Many companies kept their exchange reserves to wait for higher prices while others who needed foreign exchange for debt repayment or import of machines or raw materials were reluctant to borrow it from the bank for fear that they couldn't repay debts because of suddenly rises in the exchange rate.

To deal with this situation, the PM issued Decision 37/1998/QĐ-TTg on Feb. 14, 1998 requiring all banking institutions earning foreign exchange to deposit it with banks licensed to trade in foreign exchange or to sell it to these banks after taking away reasonable payments in foreign exchange. This Decision helped reduce the hot demand for foreign exchange.

- From Feb. 26, 1999 on: The SVB set forth the average exchange rate offered by the inter-bank market.

- On Feb. 26, 1999 the SBV Governor issued Decision 64/1999/QĐ-NHNN7 on the task of publicizing the exchange rate of the VND to foreign currencies, and Decision 65/1999/QĐ-NHNN7 on the rate offered to banking institutions licensed to trade in the foreign exchange. According to these decisions, the SBV publicized the average rate offered on the inter-bank market on a daily basis instead of publicizing the official rate and average rate on the inter-bank market. The daily rate was based on the average rate on the inter-bank market on the latest day of transaction. Banking

institutions with licenses to trade in foreign exchange could choose a rate of the VND to the dollar within 0.1% band on either side of the daily rate publicized by the SBV.

Table 1: Band for the exchange rate from Feb. 26, 1999 on

Maturity	Feb. 26, 1999 - Aug. 30, 2000	Sep. 1, 2000 - Sep. 17, 2001	Sep. 18, 2001 - June 30, 2002	From July 1, 2002 on
At call	± 0.10%	± 0.10%	± 0.10%	± 0.25%
30 days	± 0.58%	± 0.20%	± 0.40%	± 0.50%
31 - 44 days	± 0.87%	± 0.40%	± 0.40%	± 1.20%
45 - 59 days	± 1.16%	± 0.40%	± 0.40%	± 1.20%
60 - 74 days	± 1.45%	± 0.45%	± 1.50%	± 1.50%
75 - 89 days	± 1.75%	± 0.65%	± 1.50%	± 1.50%
90 - 104 days	± 2.04%	± 0.79%	± 2.35%	± 2.50%
105 - 119 days	± 2.33%	± 1.14%	± 2.35%	± 2.50%
120 - 134 days	± 2.62%	± 1.26%	± 2.35%	± 2.50%
135 - 149 days	± 2.92%	± 1.38%	± 2.35%	± 2.50%
150 - 164 days	± 3.21%	± 1.38%	± 2.35%	± 2.50%
165 - 179 days	± 3.50%	± 1.40%	± 2.35%	± 2.50%

Source: *Phát Triển Kinh Tế*, October 2002

The value of the VND was almost stable (the highest rise was 2.16% in 2002) although the price of gold and many hard currencies (such as JPY, USD, and EUR) changed remarkably. Balance of payments, balance of payments on current account and reserve in foreign exchange were improved to the highest level.

The regulation of the exchange rate, however, revealed many worrying problems. One of them is the fact that the band was too narrow and always positive, which made the rate less flexible and failed to regulate the supply of and demand for the foreign exchange.

From July 1, 2002 on, the SBV expanded the band for the exchange rate. It was the fourth time, from 1999, the SBV adjusted it. This act liberated companies and banking institutions from the so narrow band. One month after this expansion, the market rate was rather stable. By the end of July 2002, the rate offered by commercial banks and the market rate stayed at VND15,300 to the dollar, increasing by 1.13% compared with the beginning of the year and there was no remarkable difference between the two rates.

In 2003, the biggest impact on the exchange rate and foreign exchange market was rises in the price of gold. The exchange rate of the VND to the dollar that was stable in the first three quarters experienced sea changes in the last one.

To stabilize the price of gold and the exchange rate, quotas on import of gold were awarded to many importers, which helped reduced the price of gold to the one on the world market. To help companies to avoid exchange risk caused by falls in the dollar, the SBV allowed commercial banks to offer options to the public and stopped requiring

them to sell extra earnings in foreign exchange. These measures kept the rise in the inter-bank rate at 1.8% - a lowest level the years 2000-2005.

Although the price of gold skyrocketed in recent years, the exchange rate on the inter-bank market, according to the General Bureau of Statistics, rose only by 0.79% in 2004 because the dollar fell on the international markets and the supply of the dollar in Vietnam was on the increase.

From Dec. 8, 2004 on, Decision 1452/2004/QĐ-NHNN on transactions of foreign exchange between banking institutions introduced some major changes:

- Right to trade in the foreign exchange is expanded.
- Official regulations on the option operation were made.

The exchange control was less strict and a new instrument for preventing risks was introduced to the market.

- The SBV started to liberate transactions on capital and current accounts and gave more autonomy to commercial banks, which made the foreign exchange market busier and the exchange rate reflected more exactly the supply-demand relation.

In 2005 and early 2006, the war against terrorism launched by the U.S. made the dollar fall slightly against the EUR and JPY while the price of gold rose at a record speed. Up to August 2006 the market prices became stable.

Table 2: The average rate on the inter-bank market since 1999

Year	The average rate (VND/USD)	Change compared with previous year	Inflation rate
1999	14,000	1.1%	4.8%
2000	14,515	3.7%	- 0.6%
2001	15,024	3.5%	0.8%
2002	15,350	2.16%	4.0%
2003	15,630	1.82%	3.0%
2004	15,755	0.79%	9.5%
2005	15,897	0.91%	8.4%
Aug. 2006	15,980	1.00%	8.0%

Source: Ngân Hàng Magazine, 1999 - 2006

2. Estimate of effects caused by the exchange rate policy

- The current exchange rate on the inter-bank market hasn't reflected the demand-supply relation: Under the current exchange rate system, the SBV keeps publicizing the official rate and the band based on the rate offered by the inter-bank market. Operations in this market, however, are not strong enough and the volume of foreign exchange traded is not large. Many commercial banks, as its members, usually keep away from it. Intervention by the SBV is not flexible and it usually uses administrative orders instead of indirect instruments.

The transactions between banking institutions and

their customers are less flexible because they still base the transactions on the official rate and band. The sales on this market equal only a small percentage of the volume traded on the whole market. In the free market, the trade is very busy and its rate is very flexible. It even changes several times per day according to changes in the market forces, which produces pressure on the rate offered by banking institutions.

- Fixed exchange rate may harm the export and economic growth: The exchange rate in recent years has been relatively stable. It's good if it is really stable because it reflects the stable value of the domestic currency. But as everybody knows, its stability comes from the SBV effort to keep it well under control. It may be necessary for a developing country but such an exchange control will produce a negative impact on export, and in the long run, hinder the economic growth.

3. Beefing up the exchange rate policy in the global integration

In the coming years, the exchange rate policy must aim at preparing conditions for the liberation of the exchange rate in accordance with the world financial liberation and global integration. In my opinion, the reform in exchange control could take the following steps:

- Preparation for the liberation: The inter-bank market for foreign exchange must be developed better in order to attract all banking institutions. At present, however, when the foreign exchange reserve is small and finance market is in its first stage of development, the SBV had better keep controlling the exchange rate and adjust it to the market rate.

- Liberation: This process may include three steps:

(1) Expanding the band: The exchange rate is rather stable (it rose by 0.79% in 2004; 0.9% in 2005 and some 1% in 2006) and the band publicized on July 1, 2002 becomes obsolete. The SBV had better expand this band and encourage various kinds of transactions of foreign exchange in order to distribute risks better.

(2) Removing the band: This act means stopping all intervention in the changes in the exchange rate. The inter-bank rate is made known based on the supply-demand relation and objectives of the monetary policy of the period. The SBV only regulate it by using indirect instruments. Of course, this step can only take place when conditions are favorable enough.

(3) Removing the publication of the inter-bank rate: In this period, there is only a market rate based on the supply-demand relation, so the act of set forth the inter-bank rate becomes unnecessary. And as stated above, the SBV can regulate it by indirect instruments ■