

# On the Exchange Control Policy in the Years 1990 – 2005

by Dr. NGUYỄN NGỌC ĐỊNH

According to estimates by Heritage Foundation of Vietnam's indicators of economic liberation in the years 1999-2005, the Vietnamese exchange control was marked 1 (in a scale in which 1 is the highest and 5 the lowest). The exchange control policy, however, revealed some shortcomings. We had better look back on the policy in these years to identify both achievements and problems to be dealt with when implementing the exchange control.

## 1. The fixed exchange rate system before the Asian financial crisis

Besides the encouraging success caused by the floating exchange rate in 1989-92, there were many problems this exchange rate: periodic shocks at the end of the year or quarter; sudden rises in the inflation rate; widespread use of the U.S. dollar in making payment; imbalance between zones and industries; series of bankruptcies at the end of 1991; slow rises in the foreign exchange reserve in 1989-91; burdens of high rises in

Table 1: Relations between the nominal rate and PPP-based rate

	1992	1993	1994	1995	1996	1997
Nominal rate (in the VND)	11,179	10,640	10,955	10,970	11,100	11,175
Vietnamese CPI	100	105.2	120.3	135.6	141.7	146.8
American CPI	100	103.0	105.6	108.6	111.8	114.3
PPP-based exchange rate (VND)	11,179	11,388	12,702	13,992	14,132	14,320
Difference between PPP-based rate and nominal rate (%)	0.00	7.03	15.94	27.55	27.31	28.14

Source: *Tài Chính* magazine, February 2004

Table 2: Trade gap in 1993-97 (US\$ billion)

Indicator	1993	1994	1995	1996	1997
Export	2.98	4.05	5.20	7.33	9.27
Import	3.92	5.83	8.16	11.1	11.7
Trade gap	-0.94	-1.78	-2.96	-3.77	-2.43

Source: Vo Tri Thanh ed., *Exchange Rate Arrangement in Vietnam: Information Content and Policy Option*, 2000.

foreign debts on the national budget, etc.

To deal with these problems, policy makers decided to shift to the fixed exchange rate system. In addition, necessary information about the official rate, market rate and price index was made available; and the government tried its best to increase the foreign exchange reserve and formed the price stabilization fund.

The following Table 1 shows changes in the nominal exchange rate

from 1992 to the Asian financial crisis.

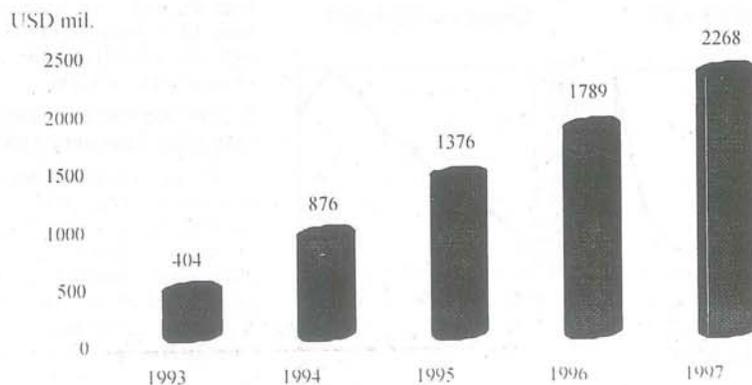
The Table shows that from 1992 to 1997, the nominal rate was rather stable. However, in comparison with the PPP-based rate, the 1997 nominal rate was 28% lower than the real rate, and this means that the VND rose by some 28.14%. That is why the absolute trade gap rose steadily (see Table 2).

The stability of the nominal rate in these years, however, helped

stabilize market prices and inflation, and encourage foreign investment, thereby allowing the growth rate to rise. This stability made the VND to be overestimated, which encouraged foreign debts for ineffective projects because investors thought the foreign exchange was cheap. This situation, in its turn, led to the unsustainable development and danger of instability.

Changes in the inflation and exchange rates in 1993-97 shows that the VND price on the market tended to stay stable or rise. This is not an encouraging sign because it implied many unfavorable consequences. An overestimated VND reduced the competitiveness of Vietnamese goods and services on foreign markets. It not only limited the export, promoted the import; but also put pressure on local production of exports and import-substitution. Although the demand for a lowered VND was on the increase, many people failed to realize it because

Figure 1: Vietnam's foreign exchange reserve in 1993 - 1997



the pressure didn't reflected in the financial and monetary system of a Vietnam in its transition period when the State control was very strict and the economy was still closed. Moreover, initial achievements of the economic reform partly covered the problems caused by the economic development, including the exchange control policy.

## 2. The fixed exchange rate with a narrow band from July 1997 to February 1999

The Asian financial crisis took place during this period. Vietnam was also affected. In addition, shortcomings of the exchange control in 1993-97 became more serious when the crisis spread, which forced Vietnam to adjust its exchange control policy.

The crisis made many Asian currencies fall against the dollar. In 1996, these currencies rose strongly against the dollar, which made the VND become more overestimated in comparison with them.

In the period from 1992 to July 1997 there was only one time the band was increased from  $\pm 1\%$  to  $\pm 5\%$  on Feb. 27, 1997 but

the rate experienced many adjustments from July 1997 to 1999.

The were many reasons for the central bank to adjust the official rate and band in this period but when taking decisions to change the exchange rate system into account, we could see that the central bank was approaching the floating rate system in comparison with the years 1992-97 although these adjustments couldn't lead to basic changes in the exchange rate system. These adjustments were basically suitable to the theory of choice of the exchange rate system. And they led some many achievements in the economic growth. According to the WB estimates presented in Country Brief: The World Bank and Vietnam, in 1998 the Vietnamese growth rate, under the influence of the Asian crisis, would be somewhere between 3.5% and 4.5% while the foreign investment could be reduced by 60% and the export rise by only 4%. In that year, in fact, the Vietnamese growth rate was 5.8%; the foreign investment reduced by only 17.5% and there was almost no increase in the trade gap. On addition, Vietnam could keep the inflation rate at 9.2%.

Generally, the exchange rate policy adopted by the SBV after the Asian crisis was right and reasonable, but it was only an urgent measure to deal with the short-term problem in order to pave the way to a long-term strategy to stabilize the exchange rate system.

## 3. The flexible exchange rate after February 1999

From Feb. 26, 1999 on, the official rate publicized on a daily basis was based on prices offered by the inter-bank market at the latest trading session. This was a mechanism for adjusting the exchange

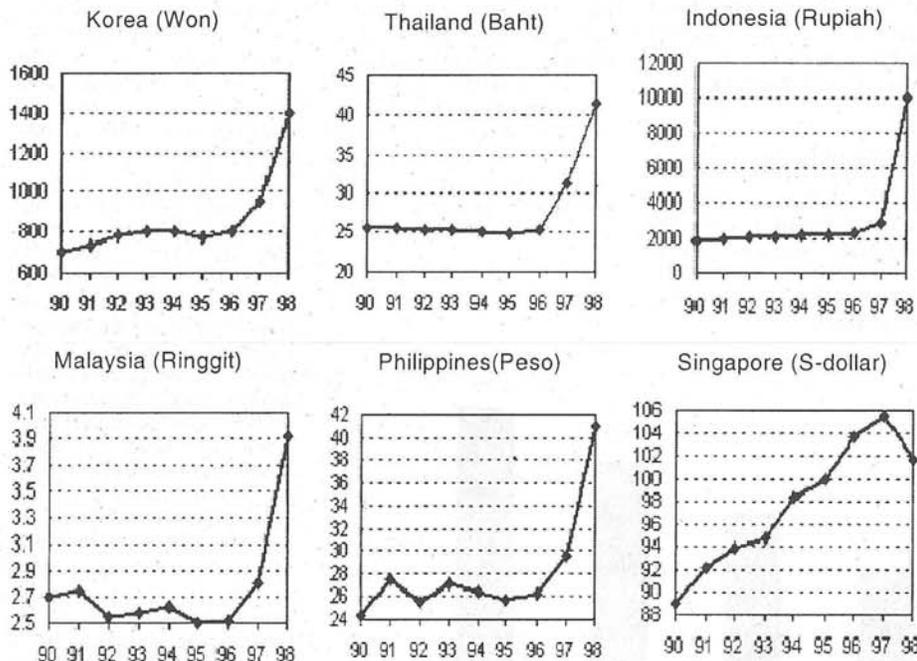
Table 3: Some macroeconomic indicators in 1993-97

Indicator	1993	1994	1995	1996	1997
Growth rate (%)	8.1	8.6	9.5	9.3	8.1
Inflation rate (%)	5.2	14.4	12.7	4.5	3.6
FDI (US\$ billion)	2.4	5.15	6.9	11	8.09

Table 4: Adjustments to the exchange rate and band

Date	Previous rate (VND/US\$)	Adjusted rate (VND/US\$)	Band after adjustment
Oct. 13, 1997			$\pm 10\%$
Feb. 16, 1998	11,175	11,800	
Aug. 7, 1998		12,998	$\pm 7\%$
Nov. 6, 1998		12,992	
Nov. 14, 1998		12,991	
Nov. 16, 1998		12,989	
Nov. 26, 1998		12,987	
Jan. 15, 1999		12,980	

Figure 2: Nominal exchange rates of some Asian currencies to the dollar



Source: World Bank, *World Development Indicators*, 2002



rate to changes in market forces because the official rate was linked closely with the market prices. The band around the rate was also reduced to  $\pm 0.1\%$  after this date.

According to the SBV, this change was a historical turning point from the fixed to a more flexible exchange rate, and the SBV only intervened when necessary. In addition, the required proportion of foreign exchange sold to the SBV was reduced from 80% to 50% of the current sales of companies, which allowed them to enjoy more autonomy in the use of foreign exchange.

Exchange control measures taken in 1999 helped stabilize the exchange rate on both official

and free markets. In this year, the exchange rate of the VND to the dollar stayed stable; the rate offered by the inter-bank market rose by 1% and one on the free market by 1.1%. In 2000, the offered rate rose by 3.45% on the inter-bank market, by 3.18% on the free market. The rate rose by 3.9% in 2001; 1.97% in 2002 and some 1% in 2003.

In this period, with the medium market rate system, the Vietnamese economy made good progress: the growth rate stayed high; the foreign debt reduced from 71.4% to 38.3% of the GDP in the years 1999-2002; and the foreign exchange reserve rose by 36.19%.

#### 4. Conclusion

The implementation of the exchange rate policy in Vietnam in recent years is no easy task. In my opinion, however, the exchange rate policy is affected too much by variants of the market. First of all, we must affirm this is necessary caution because the exchange rate is a function of too many variants (inflation rate, interest rate, trade gap, employment, foreign debt, budget deficit, external and internal balances, etc.). Foreign governments have to also deal with many problems when implementing the exchange rate policy. But a common feature in all countries is the fact that the exchange rate policy

must be a sign that allows investors to work out some future expectation for their investment.

It's worth noting that the IMF also agreed that a controlled floating exchange rate was suitable to Vietnamese conditions. But it advised Vietnam to make the exchange rate more flexible. That is why the controlled floating exchange rate in the past must be revised. In my opinion, the exchange rate policy must be flexible enough to encourage borrowers to take some responsibility for the rate risk and become more cautious. This is also suitable to efforts to integrate into the world market as required by the WTO and AFTA as well. ■

#### Reference:

1. Ass. Prof. Dr. Trần Ngọc Thơ, *Phương Pháp luận xây dựng lộ trình tự do hóa tài chính Việt Nam giai đoạn 2001- 2010* ("Methodology of the financial liberation in Vietnam in the years 2001- 2010"), 2002.

2. Ass. Prof. Dr. Trần Ngọc Thơ – Dr. Nguyễn Ngọc Định, *Tài chính quốc tế* ("International Finance"), 2001

Table 5: Some macroeconomic indicators in 1999-2002

Indicators	1999	2000	2001	2002
Real growth rate (%)	4.2	5.5	5.0	5.8
Foreign debt (as % of the GDP)	71.4	39.7	41.6	38.3
Export growth rate (%)	23.2	25.2	4.0	11.2
Import growth rate (%)	1.1	34.5	2.3	22.1
Foreign exchange reserve (US\$ billion)	2,711	3,030	3,387	3,692
Inter-bank exchange rate				
- At middle of the fiscal year	13,944	14,170	14,806	15,244
- At the end of the fiscal year	14,028	14,514	15,084	15,368
RI:ER				
- At middle of the fiscal year	-6.5	-2.9	0.9	-0.4
- At the end of the fiscal year	-3.2	-2.1	1.4	-2.7

Sources: IMF, *Vietnam: Statistical Appendix*, December 2003.