SOME OPINIONS ABOUT TWO WAYS OF INTERVENING IN FOREIGN EXCHANGE MARKET

by LÊ TIẾN HÙNG

Everyday, foreign exchange is traded by banks. In principle, the prices of currencies vary according to the supply-demand relationship. If demand is greater, the price of a currency rises and when supply is greater, the price falls, but in fact, the central bank has two ways of intervening in the market: (1) if the bank wants to lower the price, it will sell the currency at lower price thereby satisfying the demand for it and keeping the price low or unchanged, (2) to raise the price of a currency, the central bank could purchase it as best it can, because the central bank can issue the country's currency so it has the ability to buy as much foreign currency as it wants. The price of the currency will rise when the demand is greater than the supply. These two ways of intervening are usually used by central banks, but they involve both advantages and disadvantages.

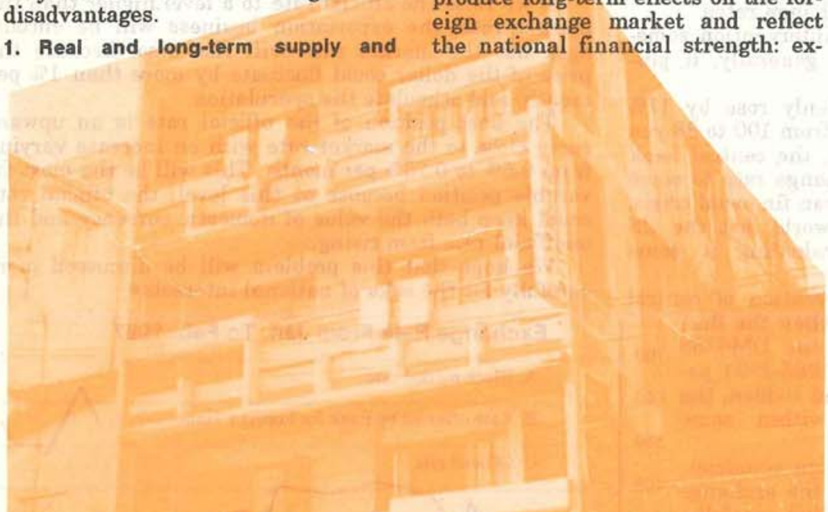
1. Real and long-term supply and demand in the foreign exchange market

The supply of foreign exchange is affected by the following factors: visible and invisible exports, immigrant remittance, foreign investment, foreign aid and loan, tourism receipts. Thinking through, foreign exchange from exports, immigrants and tourists is precious because it is under the country's ownership. These sources could be considered as "national resources" while other sources are "induced resources".

The demand for foreign exchange is affected by imports (including illegal imports), payments and interest to foreign creditors and investors, illegal transfer of money to foreign countries, loans to foreign debtors, overseas investment, aid to foreign countries, money spent abroad by tourists and students...

The supply and demand forces produce long-term effects on the foreign exchange market and reflect the national financial strength: export surplus, large amounts of immigrant remittance and tourism receipts could make Vietnam's balance of payments more favorable and the value of Vietnam's currency will rise. On the other hand, import surplus and illegal money transfer will lead to large external debts and an unfavorable balance of payments.

Many people are of the opinion that developing countries must increase imports (especially modern machines and raw materials) in order to increase investment. After industrialization, these nations could promote exportation and repay external debts. The problem is to decide what to import.



2. Short-term supply and demand

In fact, long - term demand and supply forces don't affect directly the monetary market. More important factors are short-term supply of and demand for foreign exchange needed for making payments to foreign parties. The short-term supply and demand forces affect immediately the market whereas long-term supply and demand, because of their long-term effects, stimulate only a little interest.

In Hà Nội and HCMC foreign exchange markets, representatives from commercial banks have a meeting with officials from the State Bank. Representatives from banks inform the amount of foreign exchange they want to sell or buy at the closing price of the day before. Amounts they want to buy or sell constitute supply and demand forces and certainly they aren't equal. At this time, the State Bank uses one of two intervention ways to balance supply and demand forces: if the supply is smaller than the demand, the State Bank will sell an amount of foreign exchange from its reserve (the reserve will be reduced, and if the State Bank keeps on doing this, it will run out of foreign exchange). The sale of foreign exchange by the State Bank will lead to deflation. This amount of foreign exchange could be used for importing goods and thus, increase the supply of goods and make prices fall.

If the supply of foreign exchange is greater than the demand, the State Bank will buy the surplus by increasing the money supply (the foreign exchange reserve will increase, but the bank circulation is on the increase as well and the inflation rate rises. Import restriction reduces the supply of goods and makes prices rise.)

We see that if the trading of foreign exchange is mainly of service to export-import business, the export surplus will cause inflation, because the bank has to issue more notes in circulation. In recent years in Vietnam, due to import surplus prices of foreign currencies are stable.

3. The strength of the central bank

By increasing the supply of foreign exchange or gold, or the supply of domestic currency (two totally different methods) the central bank can control the foreign exchange market. It's worth noting that most central banks in the world have used two said ways of intervening to stabilize the exchange rate, thereby avoiding sudden rises and falls in prices of foreign currencies unfavorable for the economic growth. The problem is the insensitivity of the central bank: at the meeting with representatives from commercial banks, the representative from the central bank is usually a low - ranking official who tends to accept the closing price of the day before in spite of changes in the financial strength of the central bank.

This strength comes from the foreign exchange reserve and the national economic strength (favorable or unfavorable balance of payments). If there is a great import surplus, it will be very dangerous to stabilize the foreign exchange price by selling gold and foreign exchange, because the central bank will use up its reserve no matter how big it is. After the World War II, the US had the biggest reserves in gold and foreign exchange. Years after, new exporters, such as Japan and Germany, have made their appearance and the US suffered import surplus year after year. The Federal Reserve System had to sell gold and foreign exchange to stabilize the price of the dollar, but eventually in the early 1970s the US had to depreciate the dollar. In short, even the biggest power can't keep its currency from falling, how can an underdeveloped country revaluate its currency? The reserves in foreign exchange of underdeveloped countries are usually small, or equivalent only to their imports value in six months at most, therefore selling foreign exchange from their reserves can only stabilize temporarily their monetary unit. It's more dangerous to get external debts to stabilize the monetary system. As we know, developing countries had better use external loans to import machines and materials, instead of consumer goods. We certainly have to repay principal and interest for our debts, so these debts must be used for promoting exportation so we can repay them when due.

As for the method issuing more notes to buy foreign exchange, this method has many benefits:

- Central banks have power by law to issue currency notes so they can buy as much foreign exchange as they want. This is completely different from selling foreign currencies from their reserves because their reserves are always limited. It's very difficult for them to keep on selling foreign exchange to stabilize the internal value of domestic currencies without making use of foreign loans.

In 1995, the Vietnam State Bank, by increasing the money supply, bought some US$1 billion from the black market. It could have bought more if the exchange rate were more favorable. Unfortunately it has stopped buying for fear of the inflation. If it kept on buying the dollar until now it could have accumulated some billion dollars, enough to build several factories on condition that it put more notes in circulation.

- At present, when there is "a surplus of consumer goods", an increase in bank circulation could only lead to a minor increase in market prices.

- If the exchange rate falls, both exporters and local manufacturers will gain benefits: imports become dearer and exports cheaper, exporters will earn bigger profits in domestic currency, imports will be reduced, smuggling will be prevented, importers will change into manufacturers because production is more profitable than importation.

Import surplus should be reduced and in case Vietnam imports' exceed over exports, it's better if the country buys more machines and materials and less consumer goods.

When the market prices increase, interest paid to banks seems lower because manufacturers can sell their products at higher prices. That is why the real interest rate decreases when there is inflation. This will help manufacturers repay bank loans. Contrarily, in 1996, although banks lowered their lending rate, manufacturers met with a lot of difficulties (high production cost, competition against imported goods, etc.) and failed to repay bank loans.

- In 1996, the tax take decreased because a lot of factories and companies couldn't sell their products and make profits with the result that they failed to pay tax as expected.

- If the exchange rate falls, many factories will not have to face the threat of bankruptcy because they could sell their products at higher prices■