Chapter II

CHARACTERING VIETNAM’S EXCHANGE RATE ARRANGEMENT
SINCE 1999

Since 1986, the Vietnamese Government has embarked on a comprehensive program of economic renovation (đoi moi) to transform the socio-economic system from a centrally planned economy towards a market-based system under the regulation of the Government. The doi moi program, among other things, has aimed at opening and integrating the economy with regional and global economies, in particular liberalizing trade and foreign direct investment. As a result, the Vietnamese economy has recorded remarkable achievements, particularly in economic growth. Now, Vietnam is Asia’s strongest performing economy after China. However, the economy of Vietnam still faces difficulties and challenges, above all, inefficient allocation and use of capital, inertial economic structural transformation, low competitiveness, underdeveloped infrastructure (i.e. transportation and electricity power) and financial sector, low quality of human resources, corruption, and deep-rooted bureaucracy.

In line with the economic renovation, reforms in the financial sector have also taken place. The role of the exchange rate, at the first time, was taken into consideration in 1989 by unifying official exchange rates, which were the consequence of the centrally planned economy for a long time from 1979 to 1989. Since then, exchange rate management has been continuously reformed in accordance with economic performance and with the extent of involvement in international trade and finance. A floating exchange rate regime (1989-91) aimed to devalue the Vietnamese dong that was overvalued in previous years. The long episode of a fixed exchange rate regime (1992-98) aimed to regain the stability of the Vietnamese dong after currency crisis in 1990-91. Since 1999, Vietnam has officially maintained a managed floating exchange rate regime although the currency has been de facto pegged to the U.S. dollar. Since 2005, the exchange rate system has been classified as a conventional fixed peg according to the IMF’s de facto exchange rate arrangement classification. Exchange rates of the Vietnamese dong against non-USD currencies are floated.
The first part of this chapter gives a brief look at the transition process of the exchange rate regime, aiming at providing the reader a background of the transition process of the exchange rate regime in Vietnam since *doi moi* program, thereby understanding why the SBV has chosen the managed floating exchange rate regime since 1999. The second part describes about the exchange rate regime since 1999, including institutional framework of the exchange rate regime and monetary policy. This part also assesses existing problems of the current exchange rate regime, thereby laying the issue in choice of the exchange rate regime in Vietnam in a world of increasing capital mobility, especially when the banking sector is weak and inadequately regulated and supervised.

II.1. Historical overview of the transition process of exchange rate regime since 1989

The transition process of the exchange rate regime in Vietnam has begun since 1989, after the abandonment of multilateral-exchange-rate regime. Since then, Vietnam has experienced many types of exchange rate regimes.\(^1\)

The floating exchange rate episode (1989-91) started in March 1989 by unifying a variety of official exchange rates existing in period 1978-89 into a single official exchange rate at VND 4,500 per USD (Nguyen et al., 1998). The floating exchange rate regime aimed to devalue the Vietnamese dong that was overvalued in period of conducting the centrally planned economy.\(^2\) During the episode of floating exchange rate, the nominal exchange rate depreciated by 50%. Continuous depreciation of the dong in nominal terms led to the speculation of the U.S dollar, which made the scarcity of the dollar more serious.\(^3\) The depreciation of the exchange rate, among other things, resulted in an increase in imported

\(^{1}\) See Appendix II.1.

\(^{2}\) Up to now, there has not been yet calculation that proves the dong was overvalued before 1989, but very wide spread of hundreds percent in 1985-88 between the official and black market exchange rate, as well as continuous depreciation of the official exchange rate in the period of floating has shown that the exchange rate set discretionary by the SBV before 1989 did not reflect exactly purchasing power of the dong, or in other words, the dong was overvalued.

\(^{3}\) The collapse of the Council for Mutual Economic Assistance (CMEA) placed Vietnam in situation of regular scarcity of foreign currencies because Vietnam’s foreign currency receipts, at that time, were mainly from exports to and grants of the CMEA. Meanwhile, exports to non-CMEA had not yet extended and the demand for imports was very high. Therefore, the scarcity of foreign currencies always befell (Le and Nguyen, 1999 and Chinese University of Hongkong).
input prices, thus leading to increase in cost of production, and then inflation (inflation rose double from 34.7\% in 1989 to 67.5\% in 1991, see Appendix II.2). Hence, the government had to raise nominal deposit rate to 12\% per month to ensure positive real interest rate. Being attracted by very high nominal interest rates, a great amount of the dong was deposited with credit institutions. Many People’ Credit Funds leapt at this opportunity to defraud depositors of their money, thus leading credit crashes in 1990-91. As a result, the economy fell into crisis.

Figure II.1. Nominal and black-market exchange rate, VND/USD, 1989-2007:3

![Graph showing nominal and black-market exchange rate, VND/USD, 1989-2007:3](image)

Note: Monthly average exchange rate. An upward trend means depreciation of the dong. The black-market exchange rate is selling exchange rate in Hanoi.


The floating exchange rate regime contributed to narrow the spread between the official and black-market exchange rate. However, the nominal depreciation of the dong together with the credit crashes and increase in inflation caused disorders in the economy. To stabilize the economy and to create a nominal anchor to constrain inflation, in September 1991, the SBV began adopting a fixed exchange rate regime with horizontal band. The SBV intervened to revalue the nominal exchange rate from the peak of VND 14,000 at end-1991 to VND 12,000 per USD at early 1992, and then maintained fixed exchange rate around VND 10,000-11,000 per USD in 1993-96. Initially, the trading band was set at +/-0.5\%. The stability of the exchange rate was considered as a nominal anchor to reduce inflation to very low level (from 67.5\% in 1991 to 17.5 \% in 1992, and 5.2\% in 1993).
During the Asian financial crisis in 1997-98, the speculation of the U.S. dollar occurred again, leading to pressures on the demand for the U.S. dollar. As a result, the black-market exchange rate went up strongly that made spread between the official and black-market rate further larger (Figure II.1). The trading exchange rates of commercial banks were always set at upper margin. At the same time, in the aftermath of the Asian financial crisis, currencies of other countries in the region depreciated more than the dong in nominal terms (Table II.1), leading to real effective appreciation of the dong by 8% in 1998 compared to other currencies in the region such as China, Philippines, Malaysia, and Thailand (IMF, 2000b), which, among other things, was attributed to a fall in export in 1998 (from 26.6% in 1997 to 1.9% in 1998). Facing signals of recession of the economy in 1997-98 (slower export and economic growth, and pressure on the demand for foreign currency) as well as avoiding insufficient foreign currency reserves to intervene, the SBV had to devalue three times the dong by 16.3% from VND 11,040 per USD in December 1996 to VND 11,175 at end-1997, VND 11,800 in February 1998, and VND 12,998 in August 1998. Trading band was widened from +/-1% in December 1996 to +/-5% in February 1997 and +/-10% in October 1997. When the crisis was getting calm, the band was narrowed to 7% (one-side band) in August 1998 (Figure II.2). As a result, at early 1999, the official exchange rate moved closer to the black-market exchange rate.

Table II.1. Exchange rate depreciation during the Asian financial crisis 1997-98

<table>
<thead>
<tr>
<th>National currency versus USD (%)</th>
<th>National Currency versus VND (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>National currency versus USD (%)</td>
<td>National Currency versus VND (%)</td>
</tr>
<tr>
<td>Dong</td>
<td>10</td>
</tr>
<tr>
<td>Baht</td>
<td>36</td>
</tr>
<tr>
<td>Ringgit</td>
<td>35</td>
</tr>
<tr>
<td>Won</td>
<td>37</td>
</tr>
<tr>
<td>Rupiah</td>
<td>77</td>
</tr>
<tr>
<td>Peso</td>
<td>30</td>
</tr>
</tbody>
</table>

Source: UNDP

Until early 1999, the SBV fulfilled two tasks in the management of fixed exchange rate. First, it had stabilized the exchange rate in 1992-96 contributing to stabilize macro economy and to control inflation. Second, it had adjusted the official exchange rate to be closer to the market value at early 1999. However, the SBV found that frequent adjustments of the official
exchange rate and its trading band induced the public’s scepticism about the sustainability of the exchange rate regime. In addition, the SBV still announced the exchange rate in the interbank foreign exchange market in parallel with the management and announcement of the official exchange rate. Hence, on February 26, 1999, the SBV introduced a managed floating exchange rate regime. Under this regime, the SBV announces the official exchange rate in the interbank foreign exchange market (hereafter referred as interbank-foreign-exchange-market exchange rate), which is set as the average transaction exchange rates in the interbank foreign exchange market of the previous day. Based on the previous day’s interbank-foreign-exchange-market exchange rate, credit institutions with foreign exchange license set the trading exchange rate within margin of +/-0.1% (+/-0.25% from July 2002 to December 2006, and +/-0.5% since January 2007).

**Figure II.2. Official exchange rate and trading band, VND/USD, 1991-2007:3**

![Graph of official exchange rate and trading band, VND/USD, 1991-2007:3](http://example.com/graph)

Source: SBV

**II.2. Characteristics of the exchange rate regime since 1999**

**II.2.1. Institutional framework of the exchange rate regime**

In this section, I describe some stylized facts about the institutional framework of the exchange rate regime in Vietnam.

- Exchange rate of the Vietnamese dong against the U.S. dollar announced by the SBV is built in the interbank foreign exchange market, whose participants are the SBV and credit institutions with licence for foreign exchange;
• De facto fixed exchange rate of the Vietnamese dong against the U.S. dollar and floating exchange rates of the dong against non-USD currencies (the actual, de facto regime classified by the IMF may be different from what the country officially announces);
• The SBV has intervened in the interbank foreign exchange market to stabilize the exchange rate;
• Significant fluctuation of real exchange rate;
• Beside the interbank foreign exchange market, there is also a foreign exchange market between banks and their customers, whose trading exchange rate is allowed to fluctuate within a band determined by the SBV;
• The black foreign exchange market exits because the private sector is restricted to access foreign exchange;
• Current account transaction is liberalized, but capital account transaction is restricted; and
• Foreign exchange market is underdeveloped, modern transactions are still a few.

**II.2.1.1. Exchange rate of the Vietnamese dong against the U.S. dollar announced by the SBV is built in the interbank foreign exchange market, whose participants are the SBV and credit institutions with licence for foreign exchange**

Since February 1999, the SBV has announced daily the average transaction exchange rate against U.S. dollar in the interbank foreign exchange market. The daily interbank foreign exchange market exchange rate is a basis for credit institutions to set their trading exchange rates vis-à-vis the U.S. dollar for the next transaction day plus/minus a margin determined by the SBV. Participants of the interbank foreign exchange market include State-owned Commercial Banks (SOCBs) and private banks, which have foreign exchange license (see Appendix II.3).

**II.2.1.2. De facto fixed exchange rate of the dong against the U.S. dollar and floating exchange rates of the dong against non-USD currencies**

Although Vietnam has officially adopted a managed floating exchange rate regime since 1999, the Vietnamese dong has been de facto pegged to the U.S. dollar. The actual annual nominal exchange rate depreciation against the U.S. dollar was gradually reduced from around 8% at end-1999 (in comparison with that of end of previous year) to 4% in 2000-01, 2% in 2002-03, and around 1% in 2004-06 (see Appendix II.2).
According to the IMF de facto classification, a conventional fixed peg is defined as the exchange rate fluctuates within +/- 1% band around a central rate or the maximum and minimum value of the exchange rate falls within 2% for at least three months (IMF, 2005d). Based on the SBV’s announcements in August 2004 and January 2005 about the limitation of the exchange rate depreciation within 1% and the actual nominal depreciation of the exchange rate performance (within 1% since 2004), the IMF has classified the exchange rate regime as a de facto conventional fixed peg since 2005.

Klein and Shambaugh (2006) define a fixed peg as monthly exchange rate change falls within +/-2 % band at the end of each month and over the calendar year (January-December). Calvo and Reinhart (2000) compare the volatility of changes in exchange rate with the thresholds of 1% and 2.5%. The greater the probability of exchange rate change falls within the band, the less is the floating exchange rate. As my calculation, the probability of monthly percent change of the nominal exchange rate in Vietnam within +/-1% band is 97% and 100%, respectively, in two sub-periods (Table II.2). These shares are higher than the benchmark of the United States and Japan as pure float defined by Calvo and Reinhart (2000). Regarding 2% and 2.5% threshold, the probability is 100%. In both sub-periods, the number of observations is higher than that of the U.S and Japan and that of other Asian countries. The actual behaviour of the nominal exchange rate regime shows that the Vietnamese dong has been de facto pegged to the U.S. dollar. Exchange rates of the Vietnamese dong against non-USD currencies are floated (Figure II.3).

### Table II.2. Exchange rate volatility in managed floating exchange rate regime

<table>
<thead>
<tr>
<th>Country</th>
<th>Period</th>
<th>Probability that the monthly percentage change in nominal exchange rate falls within ±1% band</th>
<th>Probability that the monthly percentage change in nominal exchange rate falls within ±2.5% band</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>February 1973 - April 1999</td>
<td>26.8%</td>
<td>58.7%</td>
</tr>
<tr>
<td>Japan</td>
<td>February 1973 - April 1999</td>
<td>33.8%</td>
<td>61.2%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>November 1978 - July 1997</td>
<td>96.4%</td>
<td>99.1%</td>
</tr>
<tr>
<td>Korea</td>
<td>March 1980 - October 1997</td>
<td>80.1%</td>
<td>97.6%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>December 1992 - September 1998</td>
<td>59.4%</td>
<td>81.2%</td>
</tr>
<tr>
<td>Singapore</td>
<td>January 1988 - April 1999</td>
<td>61.5%</td>
<td>81.9%</td>
</tr>
<tr>
<td>Vietnam</td>
<td>January 1999 - July 2004</td>
<td>97.0%</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>August 2004 - March 2006</td>
<td>100.0%</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

Source: Calvo and Reinhart (2000). Data for Vietnam is author’s calculation based on data from the IFS and the SBV.
II.2.1.3. The SBV has intervened in the interbank foreign exchange market to stabilize the exchange rate

To stabilize the exchange rate, the central bank can use two policy instruments such as interest rate and foreign exchange reserves. In Vietnam, the SBV tends to intervene in the foreign exchange market to regulate the exchange rate regime. There is the evidence that in recent years the SBV has intervened in the foreign exchange market to limit the volatility of the exchange rate.

First, the SBV two times announced its limitation of the exchange rate volatility in 2004 and 2005. That means the SBV expressed in words that they would intervene to stabilize the exchange rate.

Second, let see the performance of balance of payments and foreign exchange reserves since 2004. In parallel with the increase in capital inflows, foreign exchange reserves have been also increased (Figure II.4). In theoretic speaking, increase in capital inflows leads to excess supply in the U.S. dollar, thereby an appreciation of the nominal exchange rate. However, in
fact, the nominal exchange rate and nominal effective exchange rate depreciated in this period (Figure II.5). That means the SBV has intervened to maintain the fixed exchange rate.

Third, let see the interest rate instrument. In 2005, the SBV three times raised the refinancing- and discount interest rate (Figure II.6). In theoretical speaking, an increase in interest rates will encourage capital flows pouring into Vietnam. Increase in capital inflows, in turn, will lead to the appreciation of the nominal exchange rate. In fact, the nominal exchange rate depreciated as mentioned above. Thus, the action of raising the interest rate did not aim at regulating the exchange rate, rather controlling inflation. Therefore, it is can be concluded that the SBV has intervened in the foreign exchange market by buying and selling foreign exchange reserves to stabilize the exchange rate.

Figure II.4. Vietnam: Balance of payments and foreign exchange reserves, 1999-2006

Note: Balance of payments in percent of GDP, foreign exchange reserves in millions of U.S. dollars, data for 2006 is projected.
Source: IMF (2003c and 2006c)

II.2.1.4. Significant fluctuation of real exchange rate

The appreciation of real effective exchange rate (REER) during 1995-98 (Figure II.5) resulted from high inflation rate and strong capital inflows including foreign direct investment (FDI) and export receipts (IMF, 2003b and 2006d). In the aftermath of Asian financial crisis, currencies of other countries in the region depreciated more than the Vietnamese dong in nominal terms, leading to real appreciation of the dong in 1998. In the wake of the Asian crisis, the Vietnamese dong was under downward pressure because the capital inflows
reversed (FDI and export growth decreased), which made the NEER and REER depreciated in 1999. The NEER and REER were relatively stable in deflation episode 2000-01 (deflation episode) when export recovered. In sum, the REER appreciated by more than 30% in 1992-2000 (IMF, 2006d).

The REER has moved greatly in recent years without attentional long-term trend. The REER depreciated largely by 11.5% in 2002-04. The REER has been reversed by the appreciation since end-2004 and now, it has returned close to the level of 2001 (Figure II.5 and Table II.3). The depreciation of the REER in 2002-04 was attributed to the depreciation of the U.S.dollar against other major currencies (IMF, 2005b, p.8). In addition, the opening up of the economy to international trade is also considered as a reason making the REER depreciated (IMF, 2006d, p.55). The appreciation of the REER has resulted from high inflation since end-2004. IMF (2006c, p.30) notes that the appreciation of REER has not affected external competitiveness (given a data limitation). This is reflected by increasing share of Vietnam in world and Asia export market since 1999, though exchange rate movements had have no noticeable long-term trend. One of the most important things to enhance external competitiveness is to foster structural reform and to improve infrastructure in order to reduce costs of production, including office rent, electricity, transportations, and telecommunications costs.

The current movements of REER are consistent with economic fundamentals. Empirical study of IMF (2006a, p.12 and 2006d, p.55) finds that the Vietnamese dong currently does not appear to be significantly misaligned. The movements of REER are consistent with the Purchasing Power Parity and with key fundamentals, which are considered as net foreign assets (NFA) of the banking system and the terms of trade. An increase in NFA of 1% of GDP leads to an appreciation of REER of 2%. Higher NFA means higher income from foreign assets. With more available income in hand, the domestic consumption will be stimulated, which in turn puts upward pressure on price level and real exchange rate. Similarly, a 1-percent increase in terms-of-trade shock results in 0.6-0.7-percent increase in the REER. A rise in the price of export leads to an increase in income and in production and labour of export sector, and stronger balance of payment, which makes the price level and the REER under upward pressure (order an increase in productivity in tradable sector brings about higher wages and higher prices of non-tradables).
Figure II.5. Vietnam: Effective exchange rate indices (2000=100) and inflation (%)

Source: IMF (2002a, 2002b, 2003a, 2003c, 2006c, and 2006e) and GSO.

Table II.3. Effective exchange rate, 1995-2006

<table>
<thead>
<tr>
<th>Period average</th>
<th>Annual percentage change</th>
<th>2000=1000</th>
<th>Annual percentage change</th>
<th>2000=100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggregate</td>
<td>NEER</td>
<td>REER</td>
<td>NEER</td>
<td>REER</td>
</tr>
<tr>
<td>1995</td>
<td>-5.6</td>
<td>6.5</td>
<td>100.0</td>
<td>93.0</td>
</tr>
<tr>
<td>1996</td>
<td>4.0</td>
<td>6.6</td>
<td>104.0</td>
<td>99.1</td>
</tr>
<tr>
<td>1997</td>
<td>2.8</td>
<td>2.8</td>
<td>106.9</td>
<td>101.9</td>
</tr>
<tr>
<td>1998</td>
<td>3.7</td>
<td>8.0</td>
<td>110.9</td>
<td>110.0</td>
</tr>
<tr>
<td>1999</td>
<td>-9.7</td>
<td>-6.5</td>
<td>100.1</td>
<td>102.9</td>
</tr>
<tr>
<td>2000</td>
<td>-0.1</td>
<td>-2.8</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>2001</td>
<td>2.2</td>
<td>0.1</td>
<td>102.2</td>
<td>100.1</td>
</tr>
<tr>
<td>2002</td>
<td>-4.4</td>
<td>-1.8</td>
<td>97.7</td>
<td>98.3</td>
</tr>
<tr>
<td>2003</td>
<td>-9.4</td>
<td>-7.9</td>
<td>88.5</td>
<td>90.6</td>
</tr>
<tr>
<td>2004</td>
<td>-6.7</td>
<td>-1.4</td>
<td>82.6</td>
<td>89.3</td>
</tr>
<tr>
<td>2005</td>
<td>-1.8</td>
<td>4.3</td>
<td>81.1</td>
<td>93.1</td>
</tr>
<tr>
<td>2006</td>
<td>1.6</td>
<td>7.5</td>
<td>80.9</td>
<td>96.7</td>
</tr>
</tbody>
</table>

Note: “-”: depreciation. Data of 2006 is as of end-June and compared with Jan-June 2005

II.2.1.5. Beside the interbank foreign exchange market, there is also a foreign exchange market between banks and their customers, whose trading exchange rate is allowed to fluctuate within a band determined by the SBV.

Vietnam’s official foreign exchange market consists of an interbank foreign exchange market, where authorized dealers (credit institutions with foreign exchange license and the SBV) trade among themselves, and a market where authorized dealers (credit institutions with foreign exchange licences) transact with customers (credit institutions with foreign exchange license, bureaus de exchange, residents, and non-residents). The structure of foreign exchange market is described in Chart II.1.

**Chart II.1. Structure of foreign exchange market in Vietnam**

![Diagram of foreign exchange market](chart)


The trading exchange rate against the U.S. dollar between banks and their customers is allowed to fluctuate with a band of +/-0.5% (from January 2007) from the previous day’s interbank-foreign-exchange-market exchange rate. This band is stipulated by the SBV.

**II.2.1.6. The black foreign exchange market exits because the private sector is restricted to access foreign exchange**

In Vietnam, foreign exchange is only allowed to transact through banks (credit institutions) and bureaus de exchange with foreign exchange authorization. All transactions outside the official system mentioned above are considered as illegal. However, the black market still exists and accounts for 20% of total foreign exchange transaction volume (Nguyen, Van Tien, 2002). Market segmentation (the existence of the black market) can hamper monetary policy management because of difficulties in forecasting the money supply of the economy, reduce liquidity, and constrain financial sector development. Moreover, the operation of the black
market abets illegal economic activities e.g. smuggling, corruption, cross-border illegal remittances of foreign currency, and money laundering. Some factors make the parallel market exist:

- Resulting from the limitation for private sector to access foreign exchange of credit institution in the past, the official foreign exchange market has not met all demands for foreign exchange, especially demands of households and individuals, who want to study, cure, and travel abroad but were not legally allowed to access foreign exchange in banks. Recently, they have been allowed to buy foreign currency in banks for some purposes as regulated by the SBV, but rigid conditions make them hesitate to transact through banks, for example, submission of required documents, the obligation of opening an account with banks. Hence, households and individuals continue buying foreign currency in the black market, which favours the development of the black foreign exchange market.

- Large inward remittances from abroad, dollarization, illegal economic activities and incomes, and the preference for the dollar make foreign exchange transactions become common in the economy, which create favourable conditions for the black market to live and develop.

II.2.1.7. Current account transactions are liberalized, but capital account transactions are restricted

Current account transactions are liberalized by accepting the obligations of Article VIII, Sections 2, 3 and 4 of the IMF’s Articles of Agreement, with effect from November 8, 2005. Vietnam continues to impose restrictions on capital account transactions. Main regulations are summarized in Appendix II.4. Vietnam also maintains exchange restrictions for security reasons and has notified the IMF on April 5, 2005 that those restrictions are pursuant to Executive Board Decision No. 144 (52/51). Those are, measures have been taken to impose restrictions on financial transactions and to freeze accounts belonging to individuals and entities associated with terrorism in accordance with UN Security Council resolutions, and the list of current terrorist organizations maintained by the U.S. Secretary of State (IMF, 2005d).

Capital account transactions are still limited (controls on capital account, see Appendix II.4). However, capital account liberalization is in progress. Vietnam will open progressively the capital account by 2010 in association with opening the financial market. The opening of the
financial market will be consistent with Vietnam-U.S. Bilateral Trade Agreement, ASEAN Framework Agreement on Services (AFAS), and Vietnam’s commitments in conformity with WTO/GATS. Accordingly, the first step of opening the financial market is that Vietnam will liberate foreign entry into banking system from April 2007 (allow foreign investors to establish 100% foreign-invested banks in Vietnam). By 2009, Vietnam has to open totally its financial market. The Vietnamese dong will be made full convertible by 2010. Current account liberalization in 2005, the opening of the financial market in 2007, full convertibility of the Vietnamese dong in 2010 and partial capital account liberalization in the coming years show the increasing integration of Vietnam into global financial market.

At present, Vietnam is assessed that the economy is most vulnerable to shocks to the current account (IMF, 2006d, p.49). However, in association with the progress of capital account liberalization, vulnerability to the capital account and the financial sector is increased. For example, the portfolio inflows by foreign investors are already largely liberalized. The main restrictions are (i) all portfolio transactions by foreign investors must go through accounts with banks in Vietnam and must be in the Vietnamese dong; (ii) foreign investors are allowed to hold up to 49% of an issuer’s listed current shares (up to 30% of credit-institutions issuers). However, there is no restriction on portfolio outflows by foreign investors. That means the portfolio inflows could stop or flight out of the country at any time when there is a distress in the market, which put pressures on the SBV to defend the fixed exchange rate regime. The stability of financial sector may expose to withdrawal of foreign-currency deposits from banks by domestic agents because of the liberalization of portfolio outflows, which thereby makes it more difficult to the SBV to respond to this shock.

In short, although the liberalization of current account and progressive liberalization of capital account in Vietnam may expose the economy to current- and capital account shocks and financial instability, this liberalization and its exposures are unavoidable trend in the desire of integration into international trade and financial markets by the economy.

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4 Decision No112/2006/QD-TTg dated May 24, 2006 on ratifying project for developing Vietnamese banking sector to 2010 and orientation to 2020.

5 Although there have been not yet restrictions on capital outflows, the flight of capital flows out of the country may be slowed down because foreign investors must buy foreign exchange from banks to bring them out of the country, but banks may have not enough foreign exchange to sell to foreign investors since banks are limited by foreign exchange positions stipulated by the SBV. Nevertheless, this circumstance would not prevent the reversals of capital flows.
II.2.1.8. Foreign exchange market is underdeveloped, modern transactions are still a few

Vietnamese foreign exchange market is underdeveloped in terms of volume transactions, modern transactions, the number of participants and orders, and banking payment system.

Transactions between banks in the interbank foreign exchange market and transactions between banks and their customers are still small. The annual transaction between banks averages USD 3.4 billion in 1999-2005. In episode 1999-2002, transaction volume between banks in the interbank foreign exchange market increased slowly, even slightly decreased in two years 2001-02 (Table II.4). Since 2003, interbank transaction volume between banks has risen faster because the supply of foreign exchange has been abundant and the SBV has improved the environment for foreign exchange transactions, for example abolishing the ceiling on forward transactions, expanding forward terms (3-365 days) and allowing more eligible customers to conduct foreign exchange transactions with credit institutions (SBV, 2004). The annual average transaction volume between banks and customers in 2002-05 is USD 22.4 billion and covers only 44% of total value of export and import. Small transaction volume arises from reasons as follows (for more details, see Chapter IV, IV.1.2.1):

- In period 1999-2002, there was excess demand for foreign exchange. Foreign currency’s priority is given to SOCBs to meet the demand for strategic imports e.g. gasoline, fertilizer, and insecticide, whereas the supply of foreign currency was low and mainly relies upon export earnings, foreign exchange conversion of foreign currency holders (e.g.

6 For example, interbank transactions in Taiwan account for 62.7% of total transactions in Taipei foreign exchange market, about USD 10.7 billion daily (www.cbc.gov.tw).
7 Excess supply of foreign exchange since 2003 has been attributable to a continuing depreciation of the U.S. dollar against other major currencies, lower USD deposit interest rate than that of VND, and the lowest depreciation rate of VND have encourages foreign currency holders to convert from foreign currency into Vietnamese dong. Furthermore, the supply of foreign currency rapidly has increased thanks to increase in export earnings and inflows of overseas remittances since 2003.
8 Decision No.1452/2004/QD-NHNN dated 10 October 2004 of the SBV on foreign exchange transaction of authorized credit institutions.
9 For example, transaction volume between banks and customers in Taiwan was USD 133.7 billion in December 2006 (www.cbc.gov.tw).
foreign investors, individuals having legal earnings in the U.S. dollar) into Vietnamese dong, foreign currency deposits of the public, and the SBV’s selling foreign currency to banks. Therefore, banks always held their foreign currency to meet their clients’ demands and had not redundant foreign currency to trade in the interbank foreign exchange market. Foreign currency transaction in the interbank foreign exchange market was mainly the SBV’s selling foreign currency to banks to meet demand for import payments, accounting for 60% of total transaction volume (SBV, 2000-2005).

Table II.4. Vietnam: Transaction volume of foreign exchange market, 1999-2005

<table>
<thead>
<tr>
<th>Year</th>
<th>Interbank transaction volume between banks in billions of U.S dollars</th>
<th>Transaction volume between banks and customers in billions of U.S dollars</th>
<th>in % of export and import</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>2.54</td>
<td>n.a</td>
<td>-</td>
</tr>
<tr>
<td>2000</td>
<td>2.77</td>
<td>n.a</td>
<td>-</td>
</tr>
<tr>
<td>2001</td>
<td>2.75</td>
<td>n.a</td>
<td>-</td>
</tr>
<tr>
<td>2002</td>
<td>2.57</td>
<td>18.54</td>
<td>53.8</td>
</tr>
<tr>
<td>2003</td>
<td>3.60</td>
<td>22.80</td>
<td>53.2</td>
</tr>
<tr>
<td>2004</td>
<td>4.10</td>
<td>25.08</td>
<td>42.9</td>
</tr>
<tr>
<td>2005</td>
<td>5.29</td>
<td>23.22</td>
<td>33.4</td>
</tr>
</tbody>
</table>

Note: in billions of U.S. dollars. Vietnam’s official foreign exchange market consists of the interbank foreign exchange market and the foreign exchange market between banks and customers. Transactions in the interbank foreign exchange market include transactions between banks and transactions between the SBV and banks. Source: Author’s calculation based on SBV (2000-2005)

- Exchange rate rigidity hinders the development of the foreign exchange market. According Sarr and Lybek (2002), a liquid market tends to exhibit five characteristics: tightness (low transaction costs), immediacy (efficient trading, clearing, and settlement systems to facilitate the swift execution of orders), depth (existence of abundant orders), breadth (orders are both numerous and large in volume with minimal impact on price of individual trades), and resiliency (a wide range of active market participants to ensure that new orders flow quickly to correct order imbalances and misalignments). A fixed exchange rate hinders the development of a deep and efficient foreign exchange market because the intervention of the central bank to fix the exchange rate does not create an incentive for the public to participate in the market, to form views on the exchange rate trend, to take positions, or to manage the exchange rate risks. These may lead to scarce orders (transactions) and small market participants taking part in the foreign exchange market (more details, see Chapter IV, IV.1.2.1).
• Activities of intermediaries, who contribute to accelerate foreign exchange transactions and determine the exchange rate, in the interbank foreign exchange market do not bring into full play.

Derivative transactions play an important role in the exchange rate risk management because they are hedging instruments against exchange rate risks. Maintaining the fixed exchange rate leads to the underdevelopment of the derivative transactions because fixing exchange rate does not create perception for market participants to hedge them against exchange rate risk. This is a typical characteristic of the foreign exchange market under fixed exchange rate regime. Thus, modern transactions in Vietnam are still few and underdeveloped.

Modern transactions make up only a small share in the interbank foreign exchange market and in the foreign exchange market between banks and customers. Forward and swap transactions accounted for 7.5% of total transaction volume in the interbank foreign exchange market in period 2001-2003. Although derivatives transactions have developed fast since 2004, (forward transaction was doubles and swap transaction was six-fold in 2004; forward and swap transaction increased by 15% (SBV, 2000-2005)) derivatives products and derivatives transaction are limited. Some factors keep modern transactions underdeveloped as follows:

• Both credit institutions and enterprises are not yet familiar to modern transactions to hedge themselves against exchange rate risk. Therefore, personnel capacity, financial ability, and technological infrastructure to use these derivatives instruments are weak.
• There has not been a legal framework regulated on derivates market and instruments. Only one legal document creating favourable conditions to adopt derivatives transactions, has been just issued in November 2004 (Decree 1452). Modern transactions are firstly usually piloted in some credit institutions.
• Export-import value is still small and the U.S. dollar is mainly used in international payments (80%), whereas the exchange rate against dollar is relatively stable or depreciates at low level. This does not encourage exporters and importers to use hedging instruments.
• Strict regulations on procedures and ceilings on forward rate had discouraged the development of modern transactions (see Appendix II.5). This can be proved by a dramatic increase in forward and swap transactions in 2004 after abandoning the ceiling on forward rates and expanding forward terms (Decision No.648 on May 28, 2004).
The number of participants in the interbank foreign exchange market is small. By the end of 2005, there are about 59 participants of the interbank foreign exchange market.\(^{10}\) The number of active participants is also small. The main actors are the SBV and four SOCBs. In many transaction sessions, there were only 5 banks taking part in the transaction session. Banks tend to transact in one way in the interbank foreign exchange market, that means some banks specialize in selling (Bank for Foreign Trade, Industrial and Commercial Bank), others in buying (Bank for Agriculture and Rural Development). The SBV is the important player in the market, buying and selling foreign exchange whether on its own behalf or on the behalf of the Government. The SBV participates in the market as a last resort lender to intervene for the purpose of the monetary policy. In 1999-2002, the amount of foreign currencies transacted between the SBV and members accounted for respectively 29%, 65%, 68%, and 60% of total transaction value in the interbank foreign exchange market, of which the SBV mainly sold foreign currencies to meet demand for import payments. Since 2003, the SBV has acquired a considerable amount of foreign currencies to accumulate its international reserves. This results from the strong capital inflows in Vietnam in recent years. In addition, the SBV met timely all foreign currency requirements for the importation of petroleum and other essential goods as well as foreign investors’ needs for converting foreign currency into domestic currency (SBV, 1999-2002). However, if the SBV usually intervenes in the market, it would reduce incentives for market participants to use hedging measures to protect themselves against exchange rate exposures because they could think that the SBV would intervene to stabilize the exchange rate, thereby constraining the development of the foreign exchange market.

Payment systems, including electronic-based interbank payment system of the SBV and internal payment system of commercial banks, have been improved in recent years. Project of banking and payment system modernization, which has been funded by World Bank since 1994, has been contributed to strengthen the capacity of the payment system and will create conditions for the development of modern and multifunctional banking products and assist the SBV in conduct monetary policy. More concretely, this system allows SBV to oversee immediately the reserve funds through account balances of banks taking part in the system. It

\(^{10}\) Vietnam’s credit institutions system includes 6 SOCBs, 37 joint stock commercial banks, 31 branches of foreign banks, 5 joint venture banks, 6 financial companies, 10 financial leasing companies, 45 foreign representative offices, 1 central people’s credit fund, and 926 local people’s credit funds (www.sbv.gov.vn).
also assists the banking system to minimize flows of funds drifted in payment system and accelerates fund flows. Further, it provides timely and accurately the SBV with information on fund flows, balances of settlement accounts and settlement of capital transactions, thereby improving the efficiency of monetary policy performance. This project allows, now, participation of 52 banks (including 6 SOCBs and 46 banks) with almost 200 branches. The daily number of transactions through electronic-based interbank system is 5,625 with daily average total value of USD 635 million (SBV, 2004 and 2005).

The banking payment services have developed impressively. The number of individual account was 5 million accounts at end 2005 as compared with 1.3 million accounts at end-2004. Card market has grown very fast with more than 2 million cards has been issued in 2005 in comparison with 21 thousand cards as of end 2002. Technological infrastructure for card market has been enlarged with 1,200 ATMs, 10,000 devices (EDS and POS) and more than 11 thousand card acceptance points as of end 2005. Banks have attained some achievements in providing electronic payment services such as home banking, mobile banking, phone banking, and internet banking.

However, the modernization in Vietnamese banking system has been still behind other Asian countries. The effectiveness of banking payment system not only depends on capacity of banks, but also on the level income of inhabitants, financial capacity and ability to adopt technological facilities in banking operations. For example, modern payment system focuses on large cities. Banks’ legal capital is not large enough to equip and apply modern banking technologies, whereas banks are not allowed to equip fixed assets excess 50% of total their own capital as regulated in the Law on Credit Institutions. In banks that already have equipped modern banking technologies, ability to apply and make full use of modern features is also limited. Therefore, banking and payment modernization system has focused on SOCBs and joint stock commercial banks. In short, banking payment system has been modernizing and still not synchronizing in the whole system as well as not yet meeting all the requirements of the economy.

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11 Vietnam’s credit institutions system includes 6 SOCBs, 37 joint stock commercial banks, 31 branches of foreign banks, 5 joint venture banks, 6 financial companies, 10 financial leasing companies, 45 foreign representative offices, 1 central people’s credit fund, and 926 local people’s credit funds.
II.2.2. Monetary policy framework

Some stylized facts of monetary policy are as follows:

- The central bank, SBV, is not yet an independent organ from the Government and required to finance the government deficit.
- The monetary policy objectives are all-embracing and conflicting (economic growth, competitiveness, price-, currency- and financial system stability).
- The SBV has recently used indirect instruments in implementing monetary policy, of which reserve requirements are given priority, OMO and central bank lending facilities have been used only gradually because of underdeveloped stock market.
- The ability of the SBV to control interest rate is limited because international interest rates have affected domestic interest rates under fixed exchange rate regime despite limited capital account liberalization.
- Some reasons impede the conduct of monetary policy in Vietnam are:
  - The SOCBs frequently operate on a non-commercial basis (with a culture of policy lending subject to direct government interference).
  - The stock market has developed still a little.
  - The relationship between monetary and economic variables is instable.
  - Statistic information has not yet been sufficient.

Some functions of the SBV in monetary and exchange rate management according to Decree No.86/2002/ND-CP dated November 5, 2002 on functions of the SBV and Decree No.52/ND-CP dated May 19, 2003 on functions of Ministries and Ministry-equivalent authorities, as follows:

- Making the monetary and exchange rate policy;
- Issuing and revoking the operation licence for credit institutions;
- Supervising banking and credit activities;
- Managing foreign debts, foreign exchange reserves, foreign exchange and gold;
- Building and supervising the balance of international payments;
- Organizing the monetary market, acting as a last resort lender to intervene for the purpose of the monetary policy;
• Buying and selling foreign exchange in order to support export and import of some strategic commodities such as crude oil, gasoline, steel, cement and so on;
• Refinancing, implementing Open Market Operations (OMO);
• Organizing banking payment and information system.

**II.2.2.1. The central bank is not yet an independent organ from the Government and required to finance the government deficit**

From the legal aspect, the SBV of Vietnam is not yet an independent organ from the Government. Law on the State Bank of Vietnam 1997 (Article 1) sets out the position, functions, and objectives of the SBV and says that the SBV is a government body, thus leading to the control of the Government over the structure, functions, budget, managements, and legal framework of the SBV. The Governor is always a member of the Government (a Minister), elected and dismissed by the National Assembly under the Government’s proposal. Governor’s term follows the term of the Government and the National Assembly.

The Constitution 1992 (Article 84) and the Law on the State Bank of Vietnam (Article 3) stipulate that the National Assembly regulates monetary policy and the annual inflation rate based on the Government’s plan. In addition, the SBV also has to implement the output target stipulated by the National Assembly. That means in the formulation and execution of monetary policy, the SBV has not yet the right to define freely the goal of monetary policy. The SBV is only the body who develops plan for monetary policy on behalf of the Government to submit the National Assembly for approval (see Appendix II.6).

Additionally, the SBV is required to finance the government deficit arising from increase in government spending due to corruption and misspending, and other non-profit measures to improve well-being or aim at other targets. For example, the SBV extends non-warranted loans to the SOCBs to restructure these commercial banks, i.e. freezing, rescheduling, and writing off their debts, and providing liquidity for SOCBs’ lending to policy purposes and state project etc. Thus, it can be said that the SBV loses its independence in all three areas: personnel independence, policy independence, and financial independence.
II.2.2.2. The monetary policy objectives are all-embracing and conflicting (economic growth, competitiveness, price-, currency- and financial system stability).

Monetary policy is guided by a number of all-embracing objectives, including currency-, price- and financial system stability, the safety of monetary and banking system, economic growth, and socio-economic development (Law on the SBV 1997, Article II). The exchange rate policy aims at promoting exports, limiting imports, attracting capital inflows and accumulating foreign exchange reserves. The SBV has always announced paid much attention to maintain a favourable exchange rate for exporters because the economic growth is led by export (to avoid exchange rate misalignment). These monetary and exchange rate objectives are conflicting. For example, a supply-side shock makes inflation increase. Increase in inflation also makes exchange rate depreciate. In order to implement the objective of stability, the government must maintain stability in the exchange rate. The SBV sells foreign exchange in the market, leading to an increase in the supply of foreign exchange, then a reduction in exchange rate (appreciation). SBV’s intervention is to maintain exchange rate nearly fixed, while domestic inflation increases (higher than inflation in the United State), thus leading to real exchange rate appreciation. This, in turn, hampers export competitiveness and retards output growth. In addition, selling foreign exchange leads to a fall of money supply that means putting less money in the hands of customers, thus stifling spending, then reducing output. Moreover, due to increase in inflation, real interest rate decreases, and then deposit amount in banks decreases. Banks try to increase deposit rate in order to mobilize capital from the public and to acquire market share, thus affecting lending rate whereas the demand for capital from business firms does not increase. As a result, banks fall into interest rate “race” that affects business effectiveness of banks.

In conclusion, it can be said that it is very difficult to achieve simultaneously all objectives of monetary and exchange rate policy, especially when weak ability of the SBV to respond to shocks is further constrained by underdeveloped policy instruments (refinancing rate, discount rate, reserve requirements, and OMO) and the dominance of SOCBs that frequently operate based on non-commercial objectives.

12 “… contribute to securing the safety of banking activities and the credit institutions system; enhance the socio-economic development in a manner consistent with socialist orientation” (Nguyen, Quang Thep, 2006).
Against this background, in response to increased inflation in Vietnam since early 2004, the Government has combined monetary policy with other policies. The SBV has contracted monetary policy by raising required reserve ratio, prime, discount and refinancing interest rate, controlling credit growth and credit quality, guiding commercial banks to lend efficiently, issuing governmental bonds, and selling foreign exchange in the market to stabilize the exchange rate around VND 16,000 per USD. Besides, the Government also applied a range of administrative and fiscal measures to supplement the monetary policy. Those are lowering import tax on petroleum and steel products whose prices increase in international market, indemnifying gasoline import, applying saving measures, cutting down government expenditure and lending by SOCBs, restoring domestic fowls that were destroyed due to chicken flu epidemic, and tightening price control enforcement (Nguyen, Ngoc Tuan, 2005).

II.2.2.3. The SBV has recently used indirect instruments in implementing monetary policy, of which reserve requirements are given priority, OMO and central bank lending facilities have been used only gradually because of underdeveloped stock market

In implementing monetary policy, the central bank can use direct and indirect instruments. According to Alexander et al. (1996), the term “direct” refers to the one-to-one relationship between the instrument and the policy objective. Central banks, who use direct instruments, act directly in the market through setting regulations on prices (interest rate) or quantities (amount of credit outstanding), for example interest rate controls, credit ceilings, and directed/policy lending. In the transition process from a centrally planned economy to a market economy of developing countries, central banks shift from direct to indirect instruments (in many studies refer to market-based instruments), which are considered as more effective in increasingly open economy. By using indirect instruments, central banks as the issuer of reserve money act indirectly in the market by using their influence on money

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13 Increase in inflation rate has been attributable to: (i) increase in price of food and foodstuff due to increasing demand for consumption and export, whereas supply of food has been decreased because of avian influenza; (ii) export, investment and consumption have been increased continuously; (iii) increasing prices of input raw material and fuels (oil, petrol, iron, steel, fertilizer) lead to increase in cost of production and then goods prices; (iv) government’s adjustment of petrol prices contributes to increasing cost of production; and (v) increase in wage for worker paid from State budget spilled over wage (by 5% to 10%) in private and FDI sector (SBV, 2005).
market, for example, adjusting the demand for and supply of bank reserves (Alexander et al., 1996). The three main types of indirect instrument are open market operations, reserve requirements, and central bank lending facilities, such as rediscount and refinancing.

**Chart II.2.** Vietnam: Monetary policy instruments

![Diagram of Monetary Policy Instruments]

Although in Vietnam trading interest rates of credit institutions are liberalized and therefore influenced by foreign interest rate under fixed exchange rate, the SBV still uses direct and indirect monetary instrument to implement monetary policy, thereby regulating interest rate aiming at monetary policy objective (Chart II.2). At present, the SBV uses the prime interest rate and policy lending as direct monetary instruments. The prime interest rate was announced by the SBV since August 2000 to provide a reference rate for credit institutions and as an indicator for the market interest rate to regulate market interest rates (Figure II.6). However, this prime interest rate plays no role as the indicator for market interest rates because credit
institutions are freely to set their trading interest rates and always refer to interest rates in Singapore and London market to determine their trading interest rates. Therefore, many argue that the SBV should abandon the prime interest rate. Policy lending is lending at the mandate of the Government for national projects, projects implemented by State-owned Enterprises (SOEs), and projects for welfare reasons, rather than for commercial reasons. Policy lending affects negatively the effectiveness of monetary policy and banking system, thus it should be omitted.

The use of indirect instrument is association with the liberalization process of interest rate. Interest rate reforms towards liberalization began with the liberalization of interest rates on lending in foreign currency in June 2001. Interest rates on deposit and lending in Vietnamese dong have been liberalized since June 2002. Interest rates on foreign currency deposits of legal entities have been liberalized since March 2007. The indirect instruments of the SBV consist of reserve requirements, OMO and central bank lending facilities (refinancing and discount). Reserve requirements are prioritized. OMO and central bank lending facilities have been used gradually because of underdeveloped stock market. However, the effectiveness of reserve requirements, refinancing, and discount has not yet to be seen. Treasury bill auction market is not monetary policy instrument but this market provides goods for OMO and central bank lending facilities.

* **Reserve requirements**

Reserve requirements are differentiated by banks, currency and maturity.\(^{14}\) The SBV paid interest (1.2%) on VND required reserve. Since 2004, the SBV has not paid interest for excess reserves to prevent credit institutions’ liquidity surplus in SBV.\(^{15}\)

The SBV always uses reserve requirements as the first instrument to implement monetary policy, when inflationary pressures are modest. Otherwise, the SBV would use other monetary instruments. Reasons are, first, one of the objectives of monetary policy is to stabilize the interest rate, thereby creating favourable business conditions for credit institutions, hence contributing to macroeconomic stability. Therefore, in response to modest inflationary pressures, the SBV raises ratios of reserve requirements in order to avoid negative

\(^{14}\) Decision 796/2004/QD-NHNN on June 25, 2005 on reserve requirements with regard to credit institutions.

effects of increase in interest rates that further raise inherent-high interest rates of commercial banks. Second, the stock market is underdeveloped; the scale of market is small; types of valuable papers in the market are a few. Thus, the transmission mechanism of policy rates (refinancing and discount rates) on variables (i.e. credit supply of credit institutions, money supply) is both slow and weak. Third, the SBV limits the access of credit institutions to refinancing and discount facility (see blow).

The effectiveness of reserve requirements has not yet to be seen. We can see it through the following examples. In 1999-2000, the U.S.-dollar interest rate in the international market was continuously increased.\(^\text{16}\) Meanwhile, the U.S.-dollar deposit rate in Vietnam was lower than the international level (SBV, 2000). This made investment overseas become attractive. All banks simultaneously raised rate of foreign currency deposits (FCD) to deposit abroad (so-called interest rate “race”). To restrict credit institutions from depositing foreign currency with banks abroad, the SBV two times raised the reserve requirement ratio on short-term FCD from 5% to 8% in November 2000, and then to 12% in December 2000. These adjustments seemed to bring about no significant effects until the Fed cut down the interest rate\(^\text{17}\) and the SBV raised the reserve requirement ratio to 15% in May 2001. Another example is an inflationary tendency since early 2004. In response to inflation, the SBV, at first, raised reserve requirement ratio in July 2004. After 6 months, because inflationary situation was not improved, the SBV had to raise rediscount and refinancing rate three times in 2005 and then the prime rate (Figure II.6). These, together with increasing in Federal funds rate,\(^\text{18}\) triggered a new interest rate “race” between commercial banks through raising both the dong and foreign currency deposit rate.

* Refinancing and discount interest rate

Since March 2003, the SBV has reformed the mechanism of interest rate management by developing an interest rate corridor (Figure II.6). Accordingly, the refinancing interest rate is the ceiling rate (upper band of interest rate corridor), and the discount rate is the floor interest

\(^{16}\) Federal Funds rate increased by 28 % from 5.3% in December 1999 to 6.4% in December 2000 (www.federalreserve.gov), 3-Month US$ SIBOR rate rose from 6.06 to 6.39% during that period (www.singstat.gov.sg).

\(^{17}\) Federal funds rate went down further from 5.98% per year in January 2001 to 1.82% at end-year.

\(^{18}\) Federal funds rate increased from 1% in January 2004 to 2.79% in April 2005.
rate (lower band) in the interbank Vietnamese dong market (between banks). OMO interest rate is set flexibility in between. The refinancing and discount rate have been stipulated flexibly according to market developments. Through the discount facility, credit institutions can access the SBV’s funds subject to quota, and the maximum term of drawing is 91 days. The refinancing facility is a collateralized lending facility. The SBV limits collateralized lending and conducts the refinancing through quotas. In addition, the SBV launched and put into operation an overnight rate in October 2002, which has been used to meet temporary financing demand in electronic interbank settlements and set at 0.03% per night (or 10.8% per year) as a penalty rate. The implementation of the overnight lending rate is based on the electronic payment system that was put into operation in 2002.

The refinancing is chosen as upper band because it is per se a borrowing with security of credit institutions from the SBV. Higher refinancing interest rate than other interest rates will encourage credit institutions to seek other cheaper sources. The discount rate is chosen as lower band, as it is per se the SBV’s purchase of the valuable papers of credit institutions. The lower the discount rate, the fewer the SBV pays. In short, the SBV’s limitations in assess to the SBV’s fund (money) aim at raising the cost of the SBV’s fund, thereby controlling the banking system’s credit, hence money growth.

The financing and discount facility are underdeveloped because the following reasons. First, types of valuable papers for refinancing and discount facility are small. Second, the credit institutions, on the one hand, had not pay attention to these monetary instruments in seeking funds. On the other hand, the SBV limits the access to refinancing and discount facility, by which the refinancing rate must be higher than the market level and the discount rate must be lower than the market level. Third, only SOCBs are allowed to access the SBV’s fund through refinancing and discount (in 2006, some joint-stock commercial banks are allowed). The reasons for limiting access to these two instruments are: (i) the SBV wants credit institutions to use refinancing and discount as last source after seeking funds from deposits, lending in the interbank Vietnamese dong market, and lending through OMO; (ii) the money supply of

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20 Decision No.1085/2002/QD-NHNN on October 7, 2002 on Regulations on overdraft and overnight lending in electronic interbank payment.
banking system, which is restricted and ratified annually by the National Assembly, also limits the SBV’s ability to lending. In short, limitation in access to the SBV’s fund through refinancing and discount has weakened the effectiveness of monetary policy on economic variables.

The SBV determines credit institutions’ demand for refinancing through data on liquidity of credit institutions, which is supervised daily by the SBV and reported monthly by credit institutions. Based on data on liquidity, the SBV determines the supply of reserve money and autonomy factor. In general, the demand for refinancing is determined by the following simplified equation $RK = BR + C - ZN$, where $RK$ is refinancing credit of the SBV, $BR$ is bank reserves in the SBV, $C - ZN$ is autonomy factor, $C$ is cash and $ZN$ is currency reserves.

**Figure II.6. Interest rate corridor, 2002:06-2007:3**

![Interest rate corridor graph]

Note: in % per year
Source: SBV (2002-2005) and Nguyen, Dac Hung (2007)

In 2005, the SBV used refinancing and discount interest rate more frequently (3 times adjustments). To strengthen its ability to regulate monetary policy through indirect monetary policy instruments, at end 2005, the SBV allowed bonds issued by Development Assistance Fund and Hanoi and Hochiminh People’s Committee to be transacted in refinancing and discount transactions of the SBV to increase types of valuable papers transacted. 21

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21 Decision No1909/2005/QD-NHNN on credit institutions’ use of bond in refinancing transactions of the SBV.
Furthermore, credit institutions began paying more attention to the SBV’s refinancing and discount. Refinancing volumes increased by 50% in 2005 as compared to 2004. The number of members participating in refinancing transactions was also increased. Increase in transaction volume and expansion of participants would enhance the effect of these instruments in money market.

* Open market operations

**Figure II.7. OMO volume, 2000-05**

![OMO volume graph](chart.png)

Note: in billions of dong

The open market operations were launched in July 2000. The SBV uses OMO to regulate liquidity demand and supply of credit institutions by buying and selling valuable papers, those are supplied in the Treasury bill auction market and the stock market, thereby modulating market interest rate (Chart II.2). OMO is implemented in the money market, whose participants are credit institutions being OMO members and the SBV. The number of participants is 31 credit institutions. However, the effect of OMO is mainly on SOCBs because they are major actors in the market. Transaction volume was very small in the first four years from the launch of OMO because of a few participants and small types and volume of valuable papers. Since 2004, the OMO transaction volume has been increased, which indicates that the SBV has paid more attention to this instrument and used it as the key instrument in conducting monetary policy through the injection and withdrawal of liquidity with relative short-term of 7-56 days (Figure II.7). In 2006, the SBV acquired a large amount of foreign exchange reserves (USD 2.5 billion) and sold the SBV’s bond through OMO in order to ensure the money supply growth ratified by the National Assembly. However, the
effectiveness of this instrument still depends on the number and types of valuable papers, the number of participants, and commercial banks’ preference and attention to this instrument (for example, if commercial banks mobilize more funds from the public but their lending is not increasing accordingly, they can find OMO as a good instrument to invest).

II.2.2.4. The ability of the SBV to control interest rate is limited because international interest rates have affected domestic interest rates under fixed exchange rate regime despite limited capital account liberalization

Under a fixed exchange rate regime and interest rate liberalization, the SBV can use indirect instruments (OMO, financing, and discount) and direct instruments (prime rate) in order to regulate credit supply of credit institutions, thereby money supply and interest rate. In order to set suitable and exact policy-rates, the SBV must rely on VIBOR rate (interest rate in interbank Vietnamese dong market) and Treasury bond auction rate. However, the interbank Vietnamese dong market is underdeveloped and operates ineffectively; therefore, the interbank rate (VIBOR) is not a reference rate for the SBV to manage interest rates. In addition, the affect of the prime rate as well as other indirect instrument is not effective (as mentioned above). Therefore, the control of interest rate as an instrument to regulate the monetary market is limited.

Besides, the SBV pays more attention to harmonize the relationship between the dong deposit interest rate, exchange rate and foreign currency deposit interest rate in order to make the dong deposit rate more attractive than the foreign currency deposit rate, which aims at restricting turmoil in the monetary market due to the shift from dong deposits to FCD. Before March 2007, the SBV regulated only foreign currency deposit rate of corporate clients at credit institutions by ceiling interest rates. However, the SBV faces difficulties in interest rate control because of the following reasons:

- Domestic interest rates in Vietnam are liberalized. Commercial banks refer to interest rates in Singapore and London markets to determine their interest rates. Thus, under a fixed exchange rate regime, increase in world interest rates may affect commercial banks’ interest rates. For example, under fixed exchange rate regime, increase in the Fed rate leads to increase in interest rates in terms of U.S. dollar in Vietnam accordingly, then a rise in the demand for keeping the U.S. dollar. Commercial banks raise interest rates with
respect to the U.S. dollar in order to attract more deposits from the public. This triggers an "interest rate race", which heightens the run-out of commercial banks because they mobilized more funds but could not lend accordingly. In such a case, the SBV usually calls commercial banks to be prudent in raising their interest rates and has no better measures (the use of reserve requirement and refinancing and rediscount rate is ineffective) to prevent the shift from the Vietnamese dong to the U.S. dollar, or vice versa.

- The monetary market movements evolve complicatedly. Sometimes (1999-2001), banks are short of foreign currency, another time (since 2002), they lack of the dong to extend credit due to a smaller amount of the dong mobilization.

II.2.2.5. Some reasons impede the conduct of monetary policy in Vietnam

First, the SOCBs frequently operate on a non-commercial basis (with a culture of policy lending subject to direct government interference). The financial system is segmented by the dominance of four large SOCBs and a number of small and more dynamic foreign joint venture and domestic joint stock banks that are market-oriented. The SOCBs making up a large market share frequently finance for projects of SOEs, which is a source of nonperforming loans (NPL) and balance sheet risks (because projects of SOEs are ineffective). Policy lending affects the SBV’s regulations on credit supply of credit institutions, hence money supply (Chart II.2). Therefore, any adjustments of the SBV through indirect instruments on monetary variables may become ineffective because they do not prevent the SOCBs from new lending.

Second, although having developed dramatically in recent 12 months, the stock market has developed a little. 22 Scale (market capitalization), types of goods (valuable papers), the number of listed companies in the stock market (39 of 5000 joint stock companies as of July 21, 2006) and listed companies having good capital capacity are small. The competitiveness Vietnamese stock market came into operation in July 2000. Since mid-2006 (time for active preparation for joining the WTO), the stock market developed dramatically. At end-2006 (on December 13, 2006), the VN-Index was 740.57 points. The VN-Index has increased sharply in the first three months of 2007. It surpassed, for the first time, the threshold of 1000 points on January 30, 2007 (at 1022.40 point) and was at peak of 1133.34 points on March 19, 2007. The market capitalization is increased from USD 0.5 billion in December 2005 to USD 13.8 billion (about 22.7% of GDP) at end 2006 and 24.4 billion (38% of GDP) as of March 2007. The total equity value listed in the stock market in 2006 is increased by 528% in comparison with 2005 (SBV, www.sbv.gov.vn, and State Securities Commission of Vietnam www.ssc.gov.vn).

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ability in the international stock market is weak. Management and accounting system are not line with international standard. Investors in the stock market tend to short-term speculation. There is not supervision system over the stock market. Policies and solutions for the management and development of the stock market are slowly available.

The underdevelopment of the stock market (small scale and types of goods) has impeded the transmission of indirect instruments (refinancing, discount and OMO, whose effectiveness depends on goods and scale in the stock market) into monetary variables.

Third, the relationship between monetary and economic variables is instable. The rapid structural transformation of the financial system (such as growing monetization, and increasing internationalization of the banking system) makes it very difficult to estimate stable relationships between monetary and credit aggregates, interest rates, and other economic and financial variables (IMF, 2006a, Box 2, p.8 and IMF 2006d, p.19,66).

Last, statistic information has not yet been sufficient. Information and macroeconomic data for forecasting and conducting monetary policy have not yet been sufficient, reliable and collected on real time. This affects badly the SBV’s modelling and policy-making, and other academic researches.

II.2.3. Negative impacts of the fixed exchange rate regime on the economy

The fixed peg brings about some benefits for the economy. First, in the context of high inflation rate and lack of credibility, anchoring inflation expectations in the targeting country (Vietnam) to the inflation rate in the anchor country (US) helps to consolidate the public’s confidence in the ability of the SBV to control inflation, thereby lowering inflation expectations and hence inflation. The IMF (2006c, p.12) assesses that the fixed peg is useful in anchoring inflation expectation. In addition, the fixed peg fixes the inflation rate for internationally traded goods, and thus directly contributes to keeping inflation under control. Second, a more stable value of the Vietnamese dong provides foreign investors with a solider basis for planning and pricing, thereby lowering exchange rate risks and reducing business costs, thus, encouraging investment capital inflows to stimulate economic growth.
Apart from some benefits, the fixed exchange rate regime influences negatively on the economy as follows:

- Fixed exchange rate acts as an exchange rate guarantee and reduces the sensibility of market participants to exchange rate risks.
- The above-average increase in inflation under fixed exchange rate regime leads to real exchange rate appreciation, thereby deteriorating external competitiveness.
- Monetary policy loses its independence under fixed exchange rate regime, thus adjustments to shocks must be implemented by fiscal policy.
- It would occur a credibility problem, if market participants do not believe in the ability of the SBV to maintain the fixed exchange rate regime.
- Fixed exchange rate together with open capital account, imperfect credible monetary policy, high liability dollarization, build-up of short-term external debts and a weak banking system are likely to promote financial fragility and heighten the potential for a financial crisis.
- Weaknesses of banking and financial system sooner or later put the exchange rate under depreciation pressures, under which the SBV faces difficulties in attempting to defend the fixed exchange rate regime by adjustments such as maintaining the policy of high interest rate.

II.2.3.1. Fixed exchange rate acts as an exchange rate guarantee and reduces the sensibility of market participants to exchange rate risks

The SBV has kept the dong-US dollar exchange rate stable by restricting exchange rate movements within very narrow trading band and continues to keep it broadly stable in the near future. The fixed exchange rate seemingly creates the perception of an implicit exchange rate guarantee and reduces the sensibility of market participants to exchange rate risks; thereby they have a little incentive to hedge their foreign exchange exposures. Unhedged foreign exchange exposures together with weak financial system under fixed exchange rate become potential danger to crisis to happen. It can be explained as follows. Being guaranteed by fixed exchange rate regime, unhedged foreign-currency borrowing is promoted. Lending boom and weak bank supervisions weaken further weak-inherent banks’ balance sheets. If a negative shock in terms of trade occurs, a fall in the price of exports leads to a reduction in income and in production and labour of export sector, and a weaker position of balance of
payments. The exporters have fewer foreign exchanges and fewer people want to sell foreign exchange in the market. As a result, exchange rate depreciates. If the central bank cannot maintain the peg, a depreciation of the exchange rate can provoke banks insolvency if banks’ balance sheets are weak (for example, their liability is in foreign currency but their income is in domestic currency - currency mismatch) and their open foreign exchange positions are high. As a result, a currency crisis may happen.

Let see the foreign exchange exposure in Vietnam in episode of fixed exchange rate. About 24-25% of total credit is extended in foreign currencies. The amount of foreign currency loans (FCL) has always increased since 1999. The ratio of FCL in total loans has increased continuously since 2001 and levelled off in 2005. The ratio of FCL to FCD have doubled since 2001 (Figure II.8), from 41.2% in 2001 to 84.2% in 2005. These figures show that banks tend to increase their FCL in absolute number and the increase speed of FCL is faster than that of FCD. If this situation is not controlled, the potential foreign exchange exposure will be inevitable.

**Figure II.8. Vietnam: Foreign exchange exposure, 1999-2005**

![Diagram](image)

Source: IMF (1999b, 2003c, 2006e)

The Asian crisis is frequently taken as an example. The low volatility of exchange rates led investors to believe that the authorities were insuring them against exchange risk. Eichengreen and Hausman (1999) show that “The consequence of the combination of an exchange-rate guarantee and a financial safety net, it is argued, was to cause a large amount of short-term foreign capital to be intermediated through the banking system… To be sure, in some countries such as Thailand, banks were required to hedge their positions by acquiring
offsetting assets in foreign currency, but they did so by making foreign currency loans to domestic corporations, which became the repositories of the unhedged exposure. In other countries, notably Indonesia, companies borrowed offshore directly, but their unhedged exposures created credit risk for domestic banks that also extended them domestic-currency loans. In both cases, the accumulation of unhedged exposures was fostered by ... exchange rate stability.”

In short, the fixed exchange rate creates the perception of an implicit guarantee for exchange rate and reduces the sensibility of market participants to exchange rate risks (moral hazard problem), thereby having a little incentive to hedge foreign exposures. High liability dollarization, unhedged foreign exchange rate risk, together with tendency to borrowing in foreign currency in context of unsound financial system and inadequate banking supervision and capital account liberalization become potential danger (see below).

**II.2.3.2. The above-average increase in inflation under fixed exchange rate regime leads to real exchange rate appreciation, thereby deteriorating external competitiveness**

Vietnam uses the exchange rate as a nominal anchor to stabilize prices. Since 2004, the economy has faced high inflation rate and change in domestic inflation has been higher than that of United States, whereas the nominal exchange rate has been kept quasi-fixed, thus entailing exchange rate appreciation in the real terms. The real effective exchange rate has appreciated since end 2004 (see II.2.1.4). At present, IMF (2006c, p.30) notes that the appreciation of REER has not affected external competitiveness, given a data limitation. However, if inflation rates are increasing and strong capital flows continuously pour into Vietnam, then a large and long-lasting appreciation will sooner or later hamper Vietnam’s external competitiveness, which in turn worsens the current account and thereby retarding the output growth.

**II.2.3.3. Monetary policy loses its independence under fixed exchange rate regime, thus adjustments to shocks must be implemented by fiscal policy**

Under a pegged exchange rate, monetary policy must be subordinated to the needs of maintaining the peg. Any change in the anchor country, with whose currency the domestic currency is pegged, will affect the pegging (targeting) countries, thus the central bank must
adjust monetary policy as well. Therefore, the fixed exchange rate transmits shocks from the anchor country to the targeting country because changes in interest rates in the anchor country lead to a corresponding change in interest rates in the targeting country.

An empirical evidence of Schambaugh (2004) concludes that fixed exchange rate forces countries to follow the monetary policy of anchor countries more closely than floating exchange rate and leads to a loss of monetary policy independence. Loss of an independent monetary policy becomes problematic under fixed exchange rate regime since the pegging country loses the ability to use monetary policy to respond to domestic shocks that are independent of those hitting the anchor country. For example, if the interest rate in the anchor country (say, USA) increases because demand in this country is increasing, the interest rate in the targeting country (Vietnam) must be raised in order to maintain the exchange rate relationship, even if Vietnam is in recession. Increase in interest rate, in turn, aggravates further the recession situations through, for example, reduction in output. In addition, rise in interest rate further weakens an already fragile banking system. If banks suffer from heavy losses of loans (bad debts), increase in interest rate impedes banks from collect debts and raise the burden debt of firms, thereby probably leading to insolvency. Furthermore, increase in interest rate also aggravates fiscal deficit due to higher interest payments provided fiscal imbalance is large, and public debt is mainly short-term or contracted at floating rates.

Let see the case of Vietnam in pegging exchange rate to control inflation since 2004. At that time, commercial banks lacked of the dong to extend credit, but had excess assets in foreign currencies. In response to this situation, the SBV should reduce the reserve requirement ratio or refinancing rate as well as discount rate to help commercial banks cut down their expenses, hence they could reduce lending interest rate in foreign currency to promote enterprises to borrow in foreign currency from banks. However, monetary policy could not respond by lowering interest rates because these rates were tied to those of anchor country (the United Stated). In fact, the SBV had counter action, that is, it raised the reserve requirement ratio and the discount and refinancing rate. The reason is at that time, inflation rate was high. To respond to inflationary pressures, the SBV raised the reserve requirement ratio to control credit growth in mid-2004. Until Fed had continuously raised its rate from mid-2004, the SBV raised the discount and refinancing rate at early 2005 to force commercial

23 Due to banks has bought a large amount of foreign exchange from migrants’ remittances, disbursement of ODA and FDI, spending by foreign tourists, and mobilized a high ratio of FCD.
banks more actively in capital mobilization to reduce cash in circulation. Nevertheless, the
effectiveness of these two instruments has yet to be seen. The government, at the same time,
had to adopt tightening fiscal policy and other policies (as mentioned in II.2.2.2).
Consequently, the increase in SBV’s rates led to increase in interest rates of Vietnam’s
commercial banks as well, which triggered a new interest rate “race”. This rise in interest rate
would in turn damage the balance sheet of both enterprises and banks because banks
mobilized deposits but could not lend, and enterprises that had demand for loan would bear
higher cost for loans or do not invest any more. It also did not help banks to solve their main
problem of lacking dong capital and exceeding foreign currency deposit. Looking back on the
past, Vietnam experienced the credit crisis and currency cash due to increase in interest rates.

In short, the fixed exchange rate regime in Vietnam faces inherent problem. That is loss of
monetary independence affects the effectiveness of monetary policy. Therefore, adjustments
to shocks must be implemented by fiscal policy that is required flexible and sustainable.
However, it is not sure that the Government always supports objectives of monetary policy by
reducing its spending. In fact, the Vietnamese Government only reduced its spending in 2004,
when inflation rate was at the peak of 9.5% since 1996. After that, although the inflation rate
was still high, the Government spending was increasing (IMF, 2006e).

II.2.3.4. It would occur a credibility problem, if market participants do not believe in the
ability of the SBV to maintain the fixed exchange rate regime

Credibility refers to the degree of the confidence that the public has in the central bank’s
determination of and ability to meet its announced monetary objectives (Perrier and Amano,
2000 and Ladesma-Rodriguez et al., 2005).

A fixed exchange rate may occur the credibility problem if the public doubts about the ability
of the central bank to maintain the peg. Hence, speculative attacks are likely to be successful
and the abandonment of the peg is inevitable. Obstfeld and Rogoff (1995), Eichengreen et al.
(1999) and many other economists conclude that fixed exchange rate becomes very difficult
to sustain under high capital mobility. Opening capital account under the fixed exchange rate
regime is associated with a rise in external vulnerabilities because the capital flows easily
come into the country and they can flight out of the country at any time if there is a doubt
about the ability of the central bank to maintain the fixed exchange rate and the capital inflows are guided by short-term capital flows. It can be explained as follows.

A massive volume of capital inflows would help to supply an abundant amount of foreign exchange for the economy and lead to exchange rate appreciation. To maintain the peg, the central bank would have to intervene and thereby accumulating a great amount of foreign exchange reserves. However, in parallel with the accumulation of foreign exchange reserves is an increase in money supply, which in turn puts pressures on inflation. To cope with inflation pressures, the central bank could sterilized intervene by selling bonds through OMO. However, the ability of the economy to absorb them was limited. In some cases, the central bank would have to raise dividends of bonds to make them more attractive, which in turn would lead to increase in interest rates of the whole economy and hence capital inflows. If these pressures become too intensive, market participants would perceive that the exchange rate might be no longer sustainable (i.e. a sudden loss of credibility increases). In such a case, speculative attacks might occur. A large volume of foreign currency deposits would be withdrawn from banks. A massive volume of foreign exchange would flight out of the countries. These would lead to exchange rate depreciation, which in turn would force the central bank to intervene to defend the peg. If the intervention of the central bank would not be strong enough (because intervention in the foreign exchange market at the cost of the depletion of foreign exchange reserves, raising interest rate at the cost of weakening the health of the economy), a collapse of the fixed exchange rate would be inevitable. This situation occurred in Latin American and Asian financial crisis during the 1990s.

24 For example, net private capital flows to Thailand swung from a net inflow of 5% of GDP in 1996 to net outflows of 8% and 17% of GDP in 1997 and 1998 respectively. For five East Asian countries, net capital inflows turned from USD 0.8 billion in 1997 to USD -68 billion in 1998 (Agénor, 2004).

25 Take Sweden and the UK as example in European Exchange rate Mechanism crisis in 1992-93. Sweden began to peg its krona to European Monetary System currencies in May 1991. On 16 September 1992, in an attempt to defend the peg against speculations, the Sweden’s central bank (the Sveriges Riksbank) raised marginal overnight lending rate to 500% and hold for 4 days. Within a couple of weeks, the interest rate was lower. However, the speculators saw the precariousness of the economy and renewed their attack in mid-November. This time the Riksbank could not raise the interest rate, even above 20%. Thus, it abandoned its peg and let the krona float. In case of England, when the pound came under the attack on 16 September, the Bank of England were reluctant to raise the interest rate because there is a brief lag between the home mortgage rate and market rates. Instead, the central bank used USD 70 billion to intervene, but this effort was ineffective, the government allowed the pound to float after a few hours (Obstfeld and Rogoff, 1995).
Take the case of Vietnam. The public has not had much confidence in the ability of the SBV to control inflation because of the following reasons:

- The ability of the SBV to keep inflation under control is very weak. The public experienced the persistence of hyperinflation in Vietnam during the past decades until 1993. Excessive high inflation volatility has reduced the credibility of monetary policy. Since then, the control of inflation has been still problematic in Vietnam. After attempt at reducing hyperinflation during the 1980s and early 1990s, the economy experienced moderate inflation for only two years (1996-1997), and then came under inflationary pressures in one year later (1998). All endeavours to control inflation by tightening monetary policy led to a deflation episode (1999-2001). Measures to stimulate consumption (expansionary monetary policy), among other things, resulted in high inflation since 2004.

- The weak ability of the SBV to respond to shocks is further constrained by underdeveloped policy instruments (refinancing rate, discount rate, reserve requirements, and OMO) and the dominance of SOCBs that frequently operates based on non-commercial objectives.

- It is very difficult to achieve simultaneously all objectives of monetary and exchange rate policy because the SBV belongs to the Government (loss of independence in all three areas, personnel, finance, and formulation and implementation of the monetary policy) and has to conduct duty that contrasts to the objective of the central bank, e.g. economic growth is conflicting with the maintenance of price stability.

In face of the high-inflation history and its weak ability to keep inflation under control, the SBV has imported credibility by anchoring the value of the Vietnamese dong to the U.S. dollar. The credibility under fixed exchange rate relates to the ability of the central bank to maintain the peg, thereby controlling inflation. Normally, the SBV is able to intervene to defend the peg. The fixed exchange rate regime in Vietnam has been not yet successfully speculated until now. However, the maintenance of the peg remains a challenge to the SBV because of imperfect credibility of the public in the SBV. Take example. The exchange rate of VND 16,000 per USD is considered as a moral threshold by both authorities and the public. Whenever the dong depreciated above this threshold, market participants immediately bought the U.S.dollar for hoarding objective, causing scarcity in the foreign exchange market and giving pressure the exchange rate to depreciate. This circumstance occurred in May 2006,
leading to depreciation of the exchange rate to VND 17,000 per USD in the black market. In such a case, the SBV had to intervene to calm down the market by revaluing the dong under this moral threshold and announcing that the central bank has enough ability to keep the exchange rate stable. Other example, at end-2006, an abundant foreign exchange supply puts upward pressures on the fixed exchange rate. In such as case, the SBV did not buy foreign exchange in the market, rather widened the exchange rate band from +/-0.25% to +/-0.5%. The missing of exchange rate targeting might impair the fragile credibility of the public in maintaining the fixed exchange rate regime (more details see below).

In addition, as mentioned above, the progressive liberalization of capital account puts the maintenance of the fixed exchange rate regime in more difficult situation. This circumstance has already happened and may continue happening in Vietnam in the coming years, as Vietnam liberalizes progressively its capital account (see II.2.1.7). We see it as follows.

Being attracted by high interest rate, stable exchange rate and strong economic performance and vigorous development of the stock market, a massive amount of capital flows has poured in Vietnam in recent years, including FDI, FPI (foreign portfolio investment), ODA, and inward remittances. As a result, the REER has appreciated since 2004. To maintain the fixed exchange rate, the SBV has accumulated a large amount of foreign exchange reserves, from USD 6.3 billion in 2004 to USD 13 billion in 2006. At the same time, the SBV implemented sterilized intervention by selling Treasury bills and bonds through OMO to reduce pressures on money supply. In fact, volumes of Treasury bill auction market and OMO have increased significantly since 2004. The pressures of capital inflows on maintaining the fixed exchange rate was higher at end-2006. Generally, at the end of year, capital inflows pours sharply in Vietnam, including inward remittances, spending by Vietnamese overseas in Vietnam in the New Year, export receipts, and FDI implementation. In addition, spending by domestic agents is increased at end-year, thus they sell foreign exchange for domestic currency to meet their consumption demand in the New Year. As a result, exchange rate was under upward pressure and commercial banks had bought an abundant volume of foreign exchange from the public. However, the SBV did not buy foreign exchange from commercial banks at end-2006 because it would raise money supply ratified annually by the National Assembly. When the SBV did not buy foreign exchange from commercial banks, these banks could not buy foreign exchange from the public anymore. Otherwise, it would exceed the limit of foreign exchange position of commercial banks (not allowed to excess 30% of total equity capital/own capital).
To reduce pressures on the exchange rate management, the SBV widened the exchange rate band from +/-0.25% to +/-0.5% in January 01, 2007.

The authorities forecast that in coming years, Vietnam would continue attracting a large amount of capital inflows, especially FDI and FPI. These capital inflows might continue putting pressures on the fixed exchange rate and inflation because the SBV has to intervene in foreign exchange market to maintain the peg, which in turn puts pressures on inflation. However, the effectiveness of sterilized intervention could be limited because the ability of the market to absorb Treasury bonds would be limited. In such a case, the SBV would raise dividends of bonds to make them more attractive, which in turn would lead to increase in domestic interest rates and hence capital inflows. If these pressures become too intensive, for example, inflation is increasing, the central bank would have to widen the exchange rate band continuously, market participants would doubt that the exchange rate could not be maintained any more (a sudden loss of credibility increases). In such a case, speculative attacks might occur. A capital flight from banks and out of the country might happen. These would lead to exchange rate depreciation, which in turn would force the central bank to intervene to defend the peg. If the intervention of the SBV would not be strong enough, a collapse of the fixed exchange rate would be inevitable.

Let see reserve coverage of short-term external debts in the event of a capital flight out of the country and a run on foreign exchange deposit from banking system in Vietnam. De Beaufort and Kaptyn (2001) estimate that countries with a managed float or fixed exchange rate regime need a range of 10 to 20% of M2 to cover short-term external debt (debt falling within 1 year) in the event of capital flight. Under this benchmark, since 2002 Vietnam’s reserves have covered only the lower range (10%) but not upper range. That means Vietnam has enough foreign exchange reserves to service short-term external debts in case the volume of capital flight is 10% of M2 (M2 is used for assessing potential demand for foreign assets from domestic sources).

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26 FPI in Vietnam has increased sharply since 2006. Total FPI in the stock market is USD 3 billion until mid-2006 and at early 2007, the figure is more than USD 4 billion, making up one third of total market capitalization of USD 14 billion.

27 Commercial banks are able to buy Treasury bills and bonds through OMO but their ability to absorb high pressures on inflation deriving from an excessively expansionary money supply may be not enough to put down the upward pressures in money supply.
In addition, the IMF uses also consolidated banking sector reserves (CBSR) to find whether the country has enough reserves to cover its short-term external debts in the event of a withdrawal of foreign-exchange deposit. CBSR is relevant for Vietnam and very important to restore the market confidence. CBSR equals gross international reserves of the SBV plus reserves of deposit money banks. The minimum benchmark is the sum of short-term external debt on a remaining maturity basis and dollar deposit. The CBSR in Vietnam has hovered around the benchmark. That means the economy has enough reserves to cover its short-term external debt in the event of a withdrawal of foreign-exchange deposit.

These results show that the current reserve adequacy of Vietnam is relative positive. It can cover the short-term external debts in episode 2001-05. However, all indicators always touch the margin. Therefore, the IMF (2006d, p.44) concludes that, in the period ahead, in association with opening capital account, the pressures on reserves will be higher in time of stress.

In summary, in the coming years, in association with progressive open capital account are the pressures on the fixed exchange rate, inflation, and reserve adequacy. In such a case, de facto fixed exchange rate in Vietnam could occur the problem of credibility if market participants do not believe in the ability of the central bank to maintain the peg. Hence, a successful speculation is likely and a collapse of fixed exchange rate regime is unavoidable.

II.2.3.5. Fixed exchange rate together with open capital account, imperfect credible monetary policy, high liability dollarization, build-up of short-term external debts and a weak banking system are likely to promote financial fragility and heighten the potential for a financial crisis

Being attracted by high interest rate, stable exchange rate and strong economic performance, there is a massive volume of capital inflows in the country, which will be allocated in efficient sectors, but may be extended in inefficient sectors due to weak banking supervision (for example, using foreign exchange in projects that do not create foreign exchange incomes, using short-term loans for long-term projects - so called currency and maturity mismatch). If speculative attacks happen (as mentioned above), the capital flows would reverse (because capital inflows are guided by short-term capital flows), which in turn put the exchange rate
under downward pressures. Exchange rate depreciation would weaken already weak balance sheets of bank and firms, which in turn would force the central bank to sell foreign exchange in the market to defend the peg, but at the cost of exhaust of international reserves. To constrain the flight of capital flows, the central bank could tighten monetary policy by raising interest rates but at the cost of further weakening an already fragile banking system and affecting negatively output. These could trigger a financial crisis and a collapse of the fixed exchange rate.

Recently, Latin American and Asian financial crises during the 1990s are clear case in point. In fact, experiences of Latin America and Asia show that maintaining the fixed exchange rate while opening capital account in the context of high liability dollarization and build-up of short-term external debts and weak banking system are determinants triggered financial crises in emerging countries during the 1990s.

Take the case of Vietnam. The excessive capital inflows in association with stable exchange rate and the gap between domestic-currency and foreign-currency interest rate has promoted lending and borrowing in foreign currency. In fact, foreign currency loans rose from 19.2% in 2001 to 24.3% in 2005 of total credit to the economy (IMF, 2006e). Foreign currency deposits (dollarization) rose from USD 1.8 billion in 2000 to USD 11.4 as of June 2006. Short-terms debts could increase from 4% of GDP in 2005 to the regional average of 11.5% of GDP from 2006 onward according to a scenario estimated by IMF (2006d). In addition, being attracted by economic achievements, a dramatic growth of the stock market (one of the fastest growth all over the world) and the speed up of the equitization growth of SOEs, FPI inflows have increased sharply from USD 3 billion until mid-2006 to USD 4 billion at early 2007, making up one third of total market capitalization of USD 14 billion. These capital inflows may flight out of the country at the time of distress, leading to the imperfect credibility of the public about the ability to maintain the fixed exchange rate; hence, a speculative attack is likely to happen (as mentioned above). A run on capital flows may occur at any time if a shock originating from home countries of foreign investors forces investors to draw capital out of Vietnam (for example a cyclical recession), or a negative terms-of-trade shock will lower export prices, thereby reducing capital inflows (which was invested in export sector), or if investors change their investment strategies. In addition, the economy has some shortcomings that can make capital inflows reversals:
• Inflation in Vietnam has increased and higher than that of other Asian countries, except Indonesia (IMF, 2006d). High inflation can affect badly the effectiveness of investment and export competitiveness, thereby output growth, through increase in domestic production costs and real exchange rate appreciation. If the effectiveness of doing business in Vietnam was not ensured because of high inflation, there could be reversals of capital inflows in Vietnam (capital flows flight out of country or cessation of capital inflows).

• The stock market has developed at the highest speed in the world. The market capitalization is about 10% GDP in May 2006 and 38% GDP in March 2007. The total equity value listed in the stock market in 2006 is increased by 528% in comparison with 2005. However, revenues of listed companies have increased by about 10%. That means the stock market has the signal of asset bubble. If this bubble crashed, capital inflow reversals would be inevitable.

Because of certain reasons (mentioned above), capital inflows would slow down or be reversed (so-called sudden stop, Edwards, 2001), leading to depreciation of exchange rate. Exchange rate depreciation would raise the debt burden of domestic firms. Firms’ balance sheets would suffer exchange rate risks if they did not hedge them against exchange rate risks. Exchange rate depreciation could deteriorate balance sheets of both firms and banks if firms’ incomes were mainly in domestic currency and banks would be unable to collect the loans from firms because of increasing debt burden of firms. Exchange rate depreciation would lead to rise in both actual and expected inflation because the public have a little credibility in central bank in defending the peg. Rise in expected inflation would entails a rise in nominal interest rate, further weakening the balance sheets of firms with regard to new borrowings.

In such a case, the SBV would have to intervene to maintain the peg. However, if the intervention were delayed or insufficient to return exchange rate back to it initial level, this would increase the risk and uncertainty of the economy. When the banking system were in weakened condition, speculative attacks could be successful because speculators would believe that the central bank would dare not raise interest rates to defend the currency, which would further undermine already-weakened banks and firms. As a result, there could be a massive volume of capital flight out of the country. This would make the exchange rate further depreciated. As mentioned above, pressures on reserve coverage of short-term external debts in the event of capital flight is higher associated with capital account liberalization. In
addition, under the scenario of an increase in short-term debts to the regional average (11.5% noted above), the reserve coverage would be inadequate (IMF, 2006d, p.48). Thus, international reserves could exhaust to defend the peg. This would place the SBV in difficult situation. Additionally, in the event of adverse movements in the exchange rate, there would be a large withdrawal of foreign currency deposits, which would further weaken the health of banking system and undermine the credibility of the public in the central bank. When the fixed exchange rate would become too costly for the government to maintain, the fixed exchange rate would have to be abandoned, and the country would be forced to float its currency. Then financial crises would often happen. This is potential danger perspective that may happen in Vietnam and in fact, it already happened in emerging countries during financial crises in the 1990s.

In summary, the fixed exchange rate with open capital account may increase financial fragility and heighten the potential for financial crises if domestic liability is mainly dominated in foreign currency and short-term and the banking system is weak.

II.2.3.6. Weaknesses of banking and financial system sooner or later put the exchange rate under depreciation pressures, under which the SBV faces difficulties in attempting to defend the fixed exchange rate regime by adjustments such as maintaining the policy of high interest rate

The weakness of banking system would eventually put the exchange rate under depreciation pressure. A massive volume of capital inflows and a rapid economic growth have gone together a rise in investment and then borrowing. This led to lending boom, especially when banking sector lacks of adequate prudential regulations and supervisions. Until foreign investors perceive about the ineffectiveness of lending, they will slow down or withdraw their capital, which lead to a depreciation of the exchange rate. A depreciation of the exchange rate could deteriorate balance sheets of firms and banks (as mentioned above). A depreciation of the exchange rate might undermine banking stability, as the banking sector suffers large losses. In such a case, the central bank would have to intervene to maintain the peg. The central bank could sell foreign exchange in the market or raise the interest rate to limit the capital flight-out. However, selling foreign exchange would be at the cost of depletion of international reserves. Raising interest rates to defend the currency would further undermine already-weakened banks and firms.
In short, the weakness of banking system would eventually put the fixed exchange rate under depreciation pressure. The effects of exchange rate fluctuations on the economy depend on, among other factors, the health of the banking system. With interactions between the exchange rate and health of the banking system, the SBV has been reluctant to allow large exchange rate volatility, or in other words, the weakness in the financial system precludes the SBV from moving toward more flexible exchange rate. However, Eichengreen (1999) shows through Thailand’s crisis that delay can then be a recipe for disaster. Thailand’s authorities were repeatedly warned of the problem with their currency peg and of the need for greater exchange rate flexibility but the response was “You have a point, but we must first finish strengthening the financial system”. And we are aware of the result.

Edwards (2001) cites an analysis of Dornbusch of the Mexican crisis as follows: “Exchange rate-based stabilization goes through three phases: The first one is very useful...Exchange rate stabilization helps bring under way a stabilization...In the second phase increasing real appreciation becomes apparent, it is increasingly recognized, but it is inconvenient to do something...Finally, in the third phase, it is too late to do something. Real appreciation has come to a point where a major devaluation is necessary. But the politics will not allow that. Some more time is spent in denial, and then - sometime - enough bad news pile up to cause the crash.” Because of the devastating effects on the economy that financial crises can bring, an exchange rate pegging is a very dangerous strategy for controlling inflation in emerging countries in general and in Vietnam in particular.

Box II.1. Problems of Vietnam’s domestic financial system

Dominating problems of the financial sector is the weakness of banking system. The vulnerability of the banking system includes large foreign exchange rate exposure (23-24% of total bank credit being extended in foreign currency, of which about 50% to SOEs), high rate of nonperforming loans (NPL), double mismatch, and low profitability and competitiveness (low capital capacity and undiversified financial products).

SOCBs, which account for about 70% of the banking system’s total assets, are the strategic weak point among Vietnam’s economic institutions. SOCBs are burdened with low asset
quality, multiple mandates from the Government (e.g. extending loans to SOEs directed by the Government), significant undercapitalization, and the poor capacity of credit assessment and risk management. SOCBs’ capital adequacy ratio averages at 5.5% (where the minimum ratio is 8% according to Basel Accord).

The banks’ balance sheets are not accurately assessed because current loan classification practices do not accurately reflect customers’ ability to repay debt as well as their potential risks. As a result, banks are showing an unrealistic level of NPL. For example, according to International Accounting Standards, bad loans make up 40% of total loans, of which NPL are 58%. The IMF staffs estimate that the capital needed to bring SOCBs to solvency is about 15% of GDP at end 2003 (IMF, 2005b). Meanwhile, the ratio of NPL measured using domestic accounting standard is smaller, accounting for 15% in 2000, 7.6% in 2002, 5.8% in 2003 (Pham and Nguyen, 2005). In April 2005, the SBV adopted a new regulation on credit risk classification and provisioning (Decree 493), which is considered by the SBV as more conformed to international standards. As a result, the ratio of NPL in 2005 is 4.4% with regard to entire system, and 7.7% with regard to SOCBs. However, some are suspicious about the reality of these numbers (Pham, Thuy Ngoc, 2006).

The currency mismatch (projects generating the Vietnamese dong will be financed by the U.S. dollar) in the banks’ balance sheet has been narrowing since 2003. But given the weakness of the banking system, the banking sector is still vulnerable when the exchange rate depreciates. In addition, most enterprises borrowing foreign currency for import payment have income in domestic currency from selling imports in the domestic market. As regard to maturity mismatch (long-term projects will be financed by short-term loans), the maturity mismatch of the banking system still happened because the long- and medium-term to short-term FCD could not meet the demand. Short-term FCD makes up more than 70% of total FCD. Foreign currency credits extended by banks are mainly short-term and export-import sponsoring credits (Nguyen, Thanh Ha, 2003).

Credit is the main trading activity of banks, accounting for 70% banks’ earnings. Rapid credit expansion, uncertain loan quality, and misallocation of credit are main issues of banks’ credit activities. Rapid credit expansion was overwhelming the banks’ ability to evaluate adequately credit risk that creates risks for the quality of loan portfolios of banks that are still inexperienced at credit risk management.
The capital and money market is underdeveloped. The foreign exchange market is illiquid. Dollarization is widespread. These complicate the monetary policy management through indirect instruments.

Ability of the SBV to conduct financial and monetary policy and to supervise banking system is weak. International reserves are thin. The monetary and exchange rate policy still lack credibility in the eyes of the public and the community of investors.

The essential infrastructure (technical infrastructure, macroeconomic environment, institutional setting, market structure, and laws) is not in place to help the SBV to conduct effectively monetary policy. Information system about clients and payments is poor and underdeveloped. Banking technologies are not modern enough and adopting banking technologies is still limited because of low income of most of populations.

Source: Author

In conclusion, the fixed peg brings about some benefits for the economy in controlling inflation and reducing business costs, thereby encouraging investment capital inflows to stimulate economic growth. However, the fixed exchange rate regime influences negatively on the economy in some aspects, for example, discouraging exchange rate risk managements, deteriorating external competitiveness, loss of monetary policy independence, occurring credibility problem, increasing financial fragility and heightening potential financial crises, and putting the central bank in difficulties in monetary policy implementation, especially as the economy open its capital account. These difficulties lay the issues in choice of exchange rate regime for Vietnam.