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ABSTRACT

This paper examines Vietnam's exchange rate policy during the Asian financial crisis. It concludes that the policy of anchoring the Vietnamese Dong to the US dollar and controlled floating used by the Vietnamese monetary authorities since 1992, led to stabilisation of the exchange rate and controlled inflation during a period of rapid growth. It concludes that the risk of a financial crisis, experienced by other Southeast Asian countries was low, even if the country remained vulnerable to a currency crisis because of its current account deficit.

Since 1992, Vietnam pursued a policy of pegging its currency to the dollar through a controlled floating of the Dong on the foreign exchange market. From October 1996, the Vietnamese authorities gradually extended the Central Bank's intervention margins on the foreign exchange market, thereby allowing the Dong to decline in value, with the dollar rising from 11,000 to 13,900 Dong in October 1998, which corresponds to a depreciation of 21% of the value of Dong in dollars. This moderate depreciation contrasts with the rapid decline experienced since June 1997 by various currencies of neighbouring Asian countries, Thailand, Malaysia, the Philippines, Indonesia, which, with the exception of the latter, had previously maintained a stable exchange rate vis-à-vis the dollar.

Vietnam was therefore engaged in a policy of controlling its exchange rate, aiming at limited flexibility. This is why its experience is of considerable interest in the general debate on the good exchange rate regime of emerging countries, since it shows the choice of an intermediary strategy between total flexibility and absolute stability as it is implemented in some countries through currency boards.

The problem was whether the Vietnamese authorities would be able to continue this experiment, that is to say if they would not be forced to abandon their policy of relative nominal pegging of the Dong against the dollar in favour of a more flexible exchange rate oriented towards a depreciation of the real exchange rate. Indeed, two questions arise, which are examined here:

- Did the exchange rate policy chosen ensure that the Vietnamese economy was sufficiently competitive, especially given the consequences of the Asian crisis?

- Did the characteristics of its economy make Vietnam vulnerable to a currency crisis or a financial crisis of the sort that the economies of Southeast Asia experienced?

First, it is worth recalling the conditions under which Vietnam was led to adopt a policy of anchoring its currency and how it was able to pursue it.

Vietnam began its transition to the market economy in 1981 with the introduction of the dual pricing system, but only with the implementation of the Doi Moi policy (renovation policy) in 1986 was the economy widely and rapidly liberalised. During the implementation of the Doi Moi, the Vietnamese authorities were confronted with a massive dollarisation of the economy, which finds its currency. Strict administrative control over the holding and use of foreign currencies, as well as a complex regime of multiple exchange rates, led to the development of a tolerated parallel foreign exchange market, where the dollar exchange rate in Dong was at the beginning of 1989 almost 5 times the official rate for commercial operations, despite many large depreciations of the official exchange rate since 1981. The main problem was to give economic agents confidence in the national currency.

In October 1988, the dollarisation of the economy was legalised: businesses and individuals were able to open foreign exchange accounts in Vietnamese banks and use them freely. This reform, accompanied by a rise in interest rates on investments in Dong, had during the summer of 1989 a stabilising effect on the exchange rate of the parallel market but was short-lived because the money supply continued to grow very quickly. At the same time, the Vietnamese authorities adopted a policy of official exchange rate flexibility, so that the gap with the parallel rate would never be greater than 20%. The depreciation of the exchange rate was considerable: from December 1988 to November 1991, the official dollar exchange rate in Dongs was multiplied by 4, and during these three years, inflation was very high (35% in 1989, and about 70% in the next two years). Thus, the Vietnamese economy had entered the vicious circle of the cumulative depreciation of the currency on the foreign exchange market and on that of goods.

Given the seriousness of the situation, the monetary authorities reinforced their commitment to market exchange rate determination. In August and November 1991, two official exchange markets were opened in Ho Chi Minh City and Hanoi, in addition to the State Bank, the commercial banks and the main import-export companies. These two markets were replaced in 1994 by a national interbank currency market.

In December 1991, the monetary authorities caused a sharp decline in the dollar, of around 10%, in both official markets, as well as in the parallel foreign exchange market: on the one hand, State Bank and Vietcombank massively sold dollars on official markets; on the other hand, the State Bank announced that it was ready to meet the demand for gold from private individuals and businesses, and indeed provided unrestricted gold demand against Dongs. Given the importance Vietnamese attach to gold as a safe haven, this provision seems to have played a significant role in the credibility of the currency stabilisation policy.

As the monetary authorities simultaneously managed to control domestic credit, the dollar rate continued to fall throughout 1992 (26% overall), then stabilised between 10,500 and 11,500

Dong until 1996. Throughout this period (except in 1993), the State Bank intervened through purchases of foreign currency, to mitigate and then prevent the appreciation of Dong, as evidenced by the increase in foreign currency reserves. This continued in 1996 and 1997 even though the Vietnamese authorities allowed the Dong to depreciate moderately, which was presented as the result of a widening of the margins, the general line of policy was officially maintained.

Vietnam's exchange rate policy showed the ambiguity of the traditional distinction between fixed and floating exchange rates. Many countries that maintain an administered exchange rate practice a policy of flexibility in their exchange rate. On the other hand, at the end of 1991, Vietnam adopted a market-determined exchange rate with the aim of stabilising it while opting for a floating exchange rate, the Vietnamese authorities practiced a policy of pegging the currency.

The exchange rate stability policy pursued by Vietnam found its main justification in the intensive use of dollars in payments. It was made possible by the ability of the Vietnamese state to reduce the use of seignorage.

In a dollarised economy, two main arguments justify a policy of monetary anchoring by the exchange rate. Firstly, the permanent arbitrage that economic agents make between the holding of national currency and that of foreign currencies, according to their expectations of exchange rate variations, increases the risk of instability of the exchange rates inherent in a system of floating money. In a dollarised economy, the change in prices and the exchange rate resulting from an imbalance between money supply and demand is magnified. Indeed, during the process of adjustment to the monetary imbalance, the money supply (composed of national currency and currencies) is indexed, for its part composed of currencies, on the exchange rate and increases automatically with the depreciation of this currency rate. However, in developing economies where companies cannot use a foreign exchange market to hedge against currency risk, exchange rate volatility hampers their international activity.

Second, in a dollarised economy, the devaluation of the currency loses its effectiveness as a means of improving the trade balance. Indeed, the devaluation is supposed to act through two main channels. On the one hand, by raising the price of goods, it reduces the real value of cash balances and thus has a deflationary effect on domestic demand. Declining aggregate demand is expected to reduce the demand for imported goods and encourage businesses to seek out-of-market opportunities. But when cash balances are largely composed of foreign currencies, the magnitude of this effect is greatly reduced. On the other hand, devaluation is expected to have a relative price effect in favour of goods that are traded internationally, in other words, a depreciation of the real exchange rate. The price of exported and imported goods increases due to devaluation, which increases the profitability of export and import substitution activities, provided domestic costs rise less rapidly. In a dollarised economy, this effect is also diminished, as the price of many goods and inputs is expressed in dollars and thus indexed to the exchange rate. This was particularly the case in Vietnam for some rents. Similarly, salaries payable by joint ventures are fixed in dollars. It is likely that part of the labour remuneration is actually indexed to the exchange rate.

However, the effectiveness of monetary policy by anchoring the exchange rate depends on the conditions in which they control the money supply. Since 1991, the Vietnamese authorities had been able to drastically reduce the monetary financing of the State and, from 1992, to frame the credits of the banks to the public enterprises which at the time constituted the bulk of the credit to the economy. This credit framework had been based on a rapid reform of state-owned enterprises. In fact, many public companies merged or closed down, and one-third (900,000) of the employees were dismissed (World Bank 1996: 55). Businesses quickly restored their financial equilibrium and supplemented tax revenues (Le Dang Doanh and Mac Carty 1996).

Thus, loans to the Treasury, which from December 1989 to December 1990, had increased by 26%, increased by only 3% in 1991 and halved in 1992. Of course, in 1993, they practically doubled and found a level close to that of December 1991. In 1994, their expansion slowed down (+ 16%) to become zero in 1995 and, apparently, in 1996. From December 1991 to December 1995, their Average annual growth was only 2.2%. As for credits to state enterprises, which in 1991 had increased by 72%, their annual growth during the same period was 25%. By contrast, private sector credit, which in December 1991 accounted for only 7.2% of domestic credit, exploded, with an average annual growth of 98%, so that in December 1995 they accounted for 41% domestic credit. In total, it grew at an annual rate of 31%. At the same time, claims on the outside increased by 12% a year.

The contrasting evolution of these different counterparts in the money supply resulted in a relatively rapid expansion of the money supply: 25% per year from December 1991 to December 1995. It should be noted, however, that in Vietnam, the monetary statistics cover the Dong (banknotes and demand and term deposits) as well as the bank deposits in dollars. But, for lack of information, they did not take into account the cash in foreign notes. That's why the growth of the money supply as measured was probably overstated.

Before analysing the consequences of the Asian crisis on the Vietnamese economy, it is necessary to recall what was the situation before the crisis, because already in 1996 the continuation of the exchange rate stability policy was the object of a debate.

This policy of pegging the Dong to the dollar appears retrospectively judicious, since inflation had been largely controlled: from the beginning of 1992 to the beginning of 1996, it averaged 10% a year. On the other hand, this relative monetary stability was accompanied by strong economic growth: 8 to 10% on average per year. Yet, this policy had periodically been the subject of criticism that accused it of undermining the competitiveness of Vietnamese companies. These criticisms became more acute in 1997, after the devaluation of Asian currencies.

While the anchoring of Dong on the dollar from 1992 was accompanied, as in all countries that practise the same type of policy, a real appreciation of the national currency. There is always a degree of arbitrariness in the way of measuring the real appreciation of a currency; an approximation is given by the evolution of a real effective exchange rate index, but this depends largely on the weighting assigned to the different trading partners. Calculated with a weighting reflecting the geographical structure of the official trade of Vietnam, the index increased from the beginning of 1990 to the end of 1996 by about 20%.

It does not appear that the appreciation of the real exchange rate constituted until 1996 a handicap for the Vietnamese economy. On the one hand, the previous depreciation of the real exchange rate had been considerable, so that at the beginning of the decade, real labour compensation in Vietnam was among the lowest in the world, leaving a margin of appreciation for the real exchange rate. On the other hand, the loss of competitiveness due to the unfavourable evolution of relative prices could be offset by the increase in the productivity of factors of production. The growth in labour productivity had been remarkably rapid, not least because of massive layoffs in the public sector. It is estimated at 22% for all production from 1990 to 1996, and 50% for industry alone. On the other hand, the increase in the investment rate (which had almost doubled since 1990) was accompanied by an acceleration in growth so that the three-year capital marginal coefficient (1994-1996) was equal to 2.9, barely above its level at the beginning of the decade (2.4 in 1990-92). In comparison, in Thailand and Korea, this ratio increased from 3 to 5 during the same period.

This progress in productivity explains that despite the real appreciation of the currency, export development had been extremely rapid: from 1990 to 1996, global exports (expressed in dollars) grew on average by 27% per year and non-oil exports 28.5%. The fact that import growth was even faster than exports growth (34.4% per annum) was explained by the large increase in long-term capital inflows (multiplied by 25, or 71% annual growth), in particular in the form of direct investments, which allowed the sharp rise in the investment rate.

Thus, the appreciation of the real exchange rate in Vietnam probably did not reflect, in 1996, an overvaluation of the Dong. This conclusion seems to be corroborated by the absence of the dollar's foreign exchange premium on the parallel market compared to its official market price.

The question of a possible overvaluation of the Dong was revived by the Asian crisis. The sharp depreciation of Asian currencies helped to appreciate Vietnam's real exchange rate, as crisis-affected countries were its trading partners. According to United Nations statistics (United Nations, 1997), Vietnam's exports and imports to and from the ASEAN countries in 1994 accounted for 13 and 29% respectively of its total trade. Thus, during 1997, the appreciation of the real exchange rate weighted by the geographical structure of trade was about 8%. This appreciation was certainly not considerable; however, it was a very imperfect indicator of the impact of the depreciation of Asian currencies on the competitiveness of Vietnam.

It should first be noted that the imbalance in trade in manufactured goods between Vietnam, which remains a small country, and the Asian countries affected by the crisis was conducive to the competitiveness of Vietnamese exports. Indeed, the collapse of Asian currencies had led to a decline in the prices expressed in terms of imports from Asian countries and exports to Asian countries, but, as the relative share of imports from Asia was well higher than that of exports to this continent, on average the price of Vietnamese overall exports is less affected than that of imports; in other words, Vietnam's trade deficit vis-à-vis Asian countries had no doubt had the effect of improving the country's terms of trade.

With respect to primary commodity exports, which still made up the majority of Vietnam's exports, the decline in dollar prices combined with the stability of the exchange rate could have resulted in a lower incentive to export. However, there was a 20% increase in total exports expressed in dollars although this was lower than the 33% achieved in 1996. The slowdown in the growth of the volume of exports was in fact less, precisely because of the decline in dollar prices of the main primary products from Vietnam (rice, coffee, oil, rubber).

This slowdown in export growth was accompanied by a much more dramatic slowdown in imports (+ 0.5% in 1997 against 36% in 1996). Again, in terms of volume, this slowdown was less given the decline in dollar prices; however, it was still surprising, as the investment rate had decreased significantly and the GDP growth rate was 8.8%.

In order to assess the degree of overvaluation of a currency, it is necessary to take into account not only the change in the real exchange rate, but also exogenous factors, such as capital movements, which are susceptible to act on the balance of payments. In short, the question was whether Vietnam could, without depreciating its real exchange rate, balance the current account deficit with net capital inflows. There was reason to fear that the Asian crisis would have had a negative impact on the inflow of capital to Vietnam, since countries affected by this crisis were responsible for a large share of direct investment in Vietnam and when the industrialised countries were generally reluctant to engage in Asia.

In fact, according to the statistics available for the first 9 months of 1997 (IMF, 1997), disbursements of foreign direct investment were up by 10% compared to 1996. On the other hand, commitments were sharply decreasing for the same periods (- 67%). Indeed, Singapore, Korea, Japan and Taiwan, which accounted for almost 60% of direct investment commitments in Vietnam in 1996, decreased their commitments by 73% the following year. As commitments from non-Asian countries also declined, albeit to a lesser extent, these 4 countries still accounted for 47% of foreign direct investment commitments to Vietnam in 1997. To the uncertainty of capital movements was added that of international prices of primary products. Exports of oil, rice, fishery products, coffee, rubber and coal still constituted, in 1996, half of Vietnamese exports.

An indication of the unbalanced nature of an official exchange rate is sometimes sought in a comparison of the evolution of this price with that of the parallel market of currencies, a negative difference between the official rate of the dollar and its parallel price being then interpreted as an overvaluation of the currency. However, for a few months at the end of 1996 and in 1997, there was a negative difference (which reached a maximum of 8%), but this was later eliminated. The transitory nature of this discrepancy suggests that it did not reflect so much a shortage of foreign exchange as a reinforcement of exchange controls, or perhaps even the mere fear of a stricter application of the existing exchange provisions.

An interesting question, is why there was not a massive withdrawal? The majority of economists, following Paul Krugman, agree that the Asian crisis of 1997 was a financial crisis, linked to the behaviour of the financial system, and not a classic exchange rate crisis as in the result of the overvaluation of currencies. Vietnam's financial situation did not give rise to fears of a financial crisis similar to that experienced by its neighbours. Paul Krugman proposed an interpretation of this crisis, close to the diagnosis formulated notably by Ronald McKinnon (1988) for the countries of Latin America (Chile, Uruguay, Argentina) which, during the 1970s tried unsuccessfully to adopt a fixed exchange rate system. The argument can be schematically summarised as follows. Although the indebtedness of the financial institutions was not legally guaranteed by the governments, the idea seemed very widespread, both among the leaders of the financial institutions and their creditors (domestic and foreign), that the governments would not accept the bankruptcy of large financial intermediaries or, at least, compensate the losses of the depositors. As a result, there was a moral hazard situation in which financial institutions had the advantage of granting very risky loans (likely to yield a high return if successful) but whose expected average return would have been low if risks were taken into account. This practice was practiced in SE Asia on a large scale, through borrowing opportunities abroad which avoided the rise in interest rates but did not take foreign exchange risks into account, perhaps because of the stable stability of the exchange rate. As a result, a significant portion of loans from financial institutions went to the real estate sector or the acquisition of stakes in large business conglomerates so that asset prices (real estate and equities) rose much faster before the crisis than the consumer price index.

Although the exact situation of Asian financial systems is poorly understood, several factors contribute to this diagnosis. Thus, the growth rate of credits to the economy was in the four mentioned countries (Indonesia, Thailand, Malaysia, Philippines) well above the growth rate of the national product (at current prices), so that the ratio of Domestic credit to GDP increased sharply (reaching 130 and 136 per cent in Thailand and Malaysia) (Kirrane, 2017). Real estate loans appear to have accounted for more than 25% of outstanding loans in Malaysia and the

Philippines, and 20% in Thailand and non-performing loans amounted to 19% in Indonesia, 16% in Malaysia, 13% in the Philippines and 17% in Thailand.

The onset of the crisis was endogenous to the very mechanism that led to the rise in asset prices. It suffices that the risks that had not been correctly taken into account in the choice of projects were realised so that the price of the assets began to fall, that one became aware of the illusory nature of the guarantee of the debts by the public authorities and that a general climate of mistrust developed.

Three characteristics of the financing reinforced the crisis:

- the importance of borrowing or issuing shares compared to direct investment from abroad (from 100 to 500% depending on the country);

- the large share of the stock of short-term debt in total foreign debt, as well as the extent of financial transformation by financial intermediaries (long-term investment financing by short-term resources);

- exposure to foreign exchange risks of financial intermediaries or their clients (dollar borrowings financing investments in local currency, in the form of real estate or equity investments in non-tradable goods companies internationally).

As a result, there was a contagion of the crisis between the three markets: the exchange, the securities and the real estate markets. The depreciation of the national currency, by increasing the nominal value of the debt vis-à-vis non-residents, increased the solvency problems of the banking system and led to the liquidation of part of its assets. The fall in the price of the latter, by reinforcing the climate of mistrust, in turn increased the depreciation of the currency on the foreign exchange market.

Vietnam's financial situation appeared in many ways different from that of the Southeast Asian countries. Growth in domestic credit had been much more reasonable, so that the ratio of domestic credit to GDP had declined from 1990 to 1996 (where it was only 21%), instead of rising sharply as in the other countries. If foreign private capital flows as a proportion of GDP were of the same order of magnitude as in South-East Asian countries, the share of direct investment was much higher. In Vietnam, this difference was explained by the absence of a financial securities market and the maintenance of some exchange control for capital transactions.

As for the use of borrowed funds, it was certainly different, although the information is quite limited on this point. It seems that the share of loans for real estate was lower, and that banks had not taken significant currency risk. On the other hand, bank customers took a significant portion of their borrowing in dollars (about one-third). Moreover, most of the credit was still granted through public banks (77% in September 1997), so that state-owned enterprises received more than half (51%). Thus the risk of an Asian-style crisis in Vietnam seemed low. But the country was no less vulnerable to a more conventional currency crisis.

It is well known that, regardless of the size of its external reserves, a country cannot maintain its currency parity durably when economic agents anticipate a persistent deficit in the balance of payments. These negative expectations are generally the result of a combination of indicators such as the real appreciation of the currency linked to high inflation, the deterioration of the balance of trade or current payments, and a low rate of national savings involving a strong external borrowing to maintain growth, a large external debt making it increasingly difficult to borrow and, under the effect of these constraints, even slower growth.

From this point of view, the situation in Vietnam seemed less favourable than that of the South-East Asian countries on the eve of the crisis. The real appreciation of the currency was undoubtedly stronger. Thailand, Malaysia and the Philippines which had stabilised their currencies against the dollar since 1989-90, had experienced massive and rising capital inflows from external investors which had led to an appreciation of their real effective exchange rate. According to the calculations of Morgan Bank, compared to 1988-1992, the assessment would have been, on the eve of the crisis, 5% for Indonesia, 9% for Thailand, 13% for Malaysia, 18% for the Philippines. As for South Korea, it had experienced a significant depreciation of its real exchange rate (-13%). This weak appreciation of the real exchange rate is explained by the moderation of inflation, less than 10% in the countries mentioned. In contrast, Vietnam experienced higher inflation (14.5% in 1994, 12.7% in 1995, but only 4.5% in 1996). Savings rates in South-East Asia were remarkably high: 37% in Malaysia, 34% in Thailand, 29% in Indonesia, 20% in the Philippines in 1996, while at the same time Vietnam was only 17%. While South-East Asian countries had balanced or surplus budgets, the Vietnamese fiscal balance remained negative (-1.2% of GDP in 1996). As a result, the current account deficit was much higher in Vietnam (11.3% of GDP in 1996) than in Asian reference countries (3.3% in Indonesia, 4.7% in the Philippines, 7%, 9% in Thailand), with the exception of Malaysia where it reached 10% of GDP. However, the situation in Vietnam was better if one considers economic growth since in 1996, it rose to 9.3% against 4 to 6% in the four Asian countries mentioned above.

However, it should be noted that Vietnam ran a particular risk, linked to the dollarisation of the economy. Admittedly, it had declined thanks to several consecutive years of stable exchange rates, but had not disappeared. As already pointed out, the risk of sudden depreciation of the exchange rate due to the expectations of the economic agents is particularly high in a dollarised economies, where the economic agents arbitrate between the holding of currencies and that of national currency.

The evolution of dollarisation and its sensitivity to changes in the exchange rate cannot be precisely traced since, if one knows the bank deposits denominated in dollars, one does not know the evolution of the cash balances in foreign notes. It can only be seen that foreign currency deposits, which in December 1989 represented 28% of the money supply (currency in Dongs, demand and term deposits in Dongs and foreign currencies), constituted only 21% in 1995. The depreciation of the Dong against the dollar in 1996 and 1997 did not reverse the movement (in September 1997, the ratio was equal to 20%). The temptation to substitute dollar deposits for deposits in Dong was certainly contained by the large difference between the interest rate due on deposits in Dong (13 to 14%) and that due on deposits in dollars (6 at 7%). However, it is not excluded that cash balances in notes were more sensitive to exchange rate expectations than deposits, to the extent that they could not be offset, in the case of cash balances, by a difference in interest rates.

Given the risk of depreciation of the exchange rate related to a sudden distrust of economic agents vis-à-vis the value of the Dong, the Vietnamese authorities might have been tempted to reduce dollarisation of the economy by administrative means, in other words to limit or even prohibit the use of the dollar in transactions. Such a policy would have been at odds with the liberal policy adopted in 1989, which allowed a significant reduction in the dollarisation of the economy. On the other hand, the experience of Latin American countries facing the same situation demonstrates the illusory nature of regulatory measures in this area.

The Vietnamese authorities had already somewhat reduced the freedom of exchange for day-to-day operations by obliging companies to repatriate their export earnings to a Vietnamese bank (although this new provision appeared to be applied flexibly); on the other hand, purchases of foreign currency (except for commercial transactions) were limited to $500 (against 7,000 previously). It would certainly have been much more serious, for confidence in the national currency, to prevent the holders of dollar accounts in banks from withdrawing dollars, as suggested by the rumour that had been running periodically since the beginning of 1998, fueled by apparently contradictory statements by the Vietnamese authorities.

To prevent Vietnam from experiencing a currency crisis, it was necessary to accelerate the reforms undertaken for several years to maintain its competitiveness. On the one hand, it was macroeconomic policy aimed at controlling aggregate demand and thereby slowing price increases, and even more structural policies (on the supply side) aimed at increasing business productivity. If, since 1992, Vietnam had managed to maintain the stability of its exchange rate, it was thanks to a remarkable budgetary effort that had enabled it to eliminate any monetary financing of the budget deficit.

The lessons of the Asian crisis argued for a strengthening of banks and the monitoring of the financial system. They justified regulation of capital transactions favourable to direct investments, but restrictive with respect to foreign financial investments, especially in the short-term. In this respect, Vietnam drew inspiration from the policies of certain Latin American countries (Mexico, Chile, Colombia) which acted in these two directions after the Mexican crisis of 1994 and escaped the Asian storm.

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