

An Assessment of the Macroeconomic Challenges Facing Vietnam in a Post-WTO Environment: Inflation, Exchange Rates, and the Sustainability of Growth and Stability

by

James Riedel

William L. Clayton Professor of International Economics
Johns Hopkins University School of Advanced International Studies (Washington, DC)
and
Senior Economic Advisor
STAR-Vietnam Project (Hanoi)

This paper was prepared in response to a request to the USAID-STAR Project by Vietnam's Office of the Government to assess the evolving challenges of managing Vietnam's macroeconomy in an increasingly open, post-WTO environment. The request specifically asked to evaluate the causes of the recent surge in inflation and rise in the current account deficit and the policy options for sustaining the rapid economic growth required to meet Vietnam's socio-economic goal of becoming a middle-income country by 2010. The USAID-funded STAR Project responds on a demand-driven basis to technical assistance requests by State agencies as approved by STAR's Government Steering Committee to support the implementation of the U.S.-Vietnam Bilateral Trade Agreement and WTO commitments, including supporting the development of the legal, economic and institutional capacities and policies needed to achieve Vietnam's ambitious socio-economic objectives..

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Assessing Macroeconomic Challenges Facing Vietnam in a Post-WTO Environment: Inflation, Exchange Rates, and the Sustainability of Growth and Stability

Vietnam is a poor country, with a per capita income of about \$775, but it is growing rapidly. For the past three years (2005-2007), Vietnam's economy grew at the prodigious rate of 8.3 percent, on a per capita basis about 7 percent per annum, the rate at which per capita income doubles every 10 years. Few countries have ever matched Vietnam's current rate of growth, but Vietnam still has a long way to go to catch up with its neighbors that got a head start. At an annual rate of growth of 7 percent it will take Vietnam two decades to reach the current level of per capita income in Thailand (about \$3300 in 2007).¹ If per capita income in Thailand grows only half as fast as in Vietnam, it will take Vietnam, with a per capita income growth at the gold medal rate of 7 percent, more than four decades to catch up with Thailand. These are inexorable facts, not of economic theory or empirical analysis, but of the arithmetic of compound growth rates. They serve nonetheless to make an important point: *sustainability is the name of the game*. Rapid growth is not enough; it must be sustained for decades in order for Vietnam to become a prosperous country.

In the past year, the sustainability of Vietnam's rapid growth began to be questioned because of an abrupt rise in the rate of inflation. From 1996 to 2006, consumer prices rose at an average annual rate of 4.4 percent. Then, in 2007, the rate of inflation soared to 12.5 percent and in February 2008 hit an annualized rate of 15.7 percent.² Immediately, questions arose as to whether Vietnam can sustain its high growth rate with inflation in double-digits and accelerating. Also at issue is whether inflation can be reined in by the authorities without sacrificing the country's growth prospects in the near if not long term. An attempt is made here to answer those questions and provide a perspective on the nature of the threat to the sustainability of long term growth and stability in Vietnam.

¹ The values of per capita income for Vietnam and Thailand are from the Asian Development Bank, *Key Indicators*, 2007, <http://www.adb.org/statistics>.

² Investment bank HSBC forecasts inflation for 2008 above 16 percent. HSBC, *Vietnam Monitor* (Issue 12) 2 April 2008.

The first part of this paper analyzes the forces behind the acceleration of inflation since 2006 and the policy options the government faces. The second part of the paper examines similar macroeconomic challenges that China faced in recent years and the Chinese authorities' responses to them, the aim being to identify lessons that may be useful for Vietnam. The final part of the paper assesses the policy options Vietnam faces and analyzes the nature of the threat to long term growth from macroeconomic instability and other potential weaknesses in the foundation on which Vietnam's prospects for long-term growth rest.

1. Evolving Macroeconomic Challenges

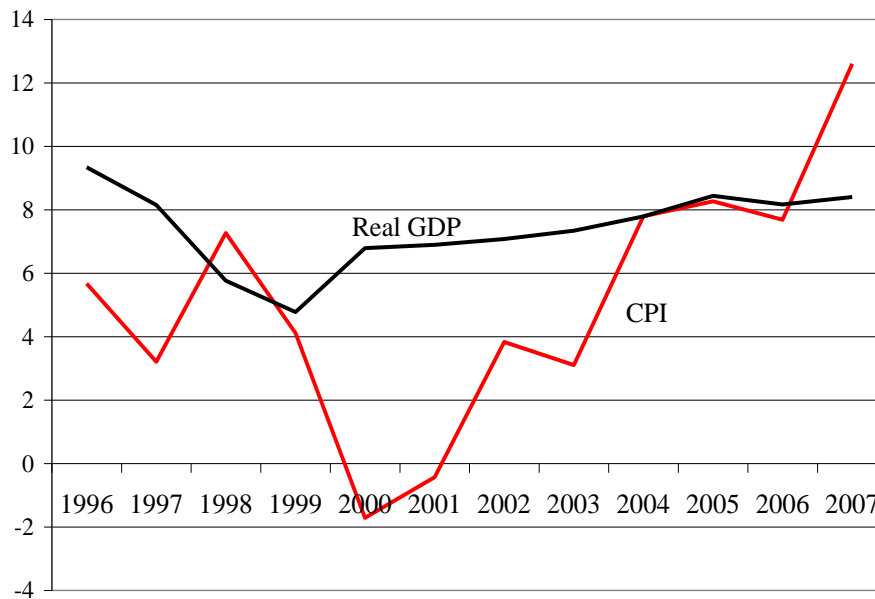
a. The record³

Vietnam has enjoyed high growth and low inflation the past 15 years. As Figure 1 indicates, since 2000 the real GDP growth rate has been rising, but so too has inflation, and in 2007 went into double-digits for the first time in more than a decade. The rise in the rate of inflation has brought back bad memories from late 1980s and early 1990s. Although the inflation rate in 2007, at 12.7 percent, was far below what it was in the early 1990s (e.g., 72 percent in 1991), it is nonetheless a matter of great concern, not only to the authorities in-charge, but also to ordinary Vietnamese who see their real wages eroding.⁴

³ Analysis of the current macroeconomic situation in Vietnam is severely hampered by the lack up-to-date data. The government of Vietnam does not make available comprehensive and timely macroeconomic data. The IMF's *International Financial Statistics* (IFS) reports data for Vietnam, but (as of March 2008) only through 2005. The statistical appendix of the IMF Country Report No. 07/386, issued in December 2007, provides data through 2006, but those data contain many significant discrepancies with data from the IFS for years prior to 2006. The focus of much of what is discussed here occurred in 2007, for which there are neither official government nor IMF data. We have therefore had to piece together a statistical picture of the macro economy in 2007 using estimates and forecasts from the press and from periodic reports of international investment banks and foreign investment funds based in Vietnam.

⁴ Any Kazmin, "Vietnam faces strikes by workers as price rises threaten economic gains," *Financial Times* (London). January 10, 2008, p.5; Greg Torode, "Inflation threatens privileged generation," *South China Morning Post*, March 15, 2008, p.15.

Figure 1: Real GDP Growth Rate and the CPI Inflation Rate: 1996-2007
(percentages)

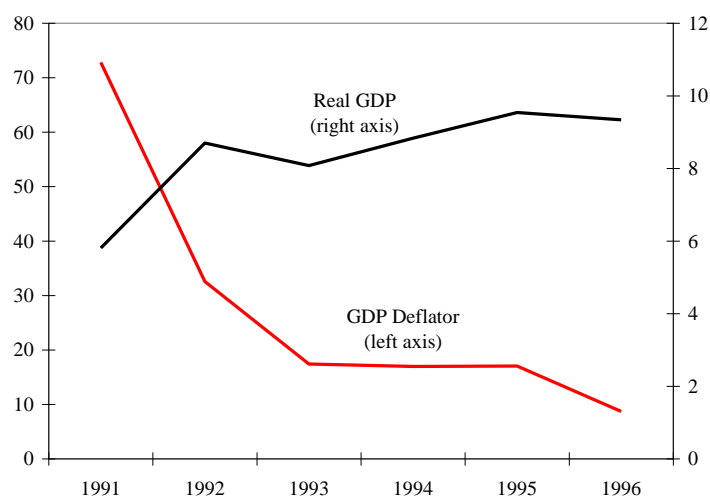


Source: Appendix 1.

In the early 1990s, high inflation was a legacy of an economic system that the authorities were abandoning in favor of a market economy. By slashing government spending and reining in credit growth, the authorities were able to lower the inflation rate dramatically without jeopardizing economic growth, which was responding positively to measures taken concurrently to remove (or at least to reduce) gross inefficiencies in the economy inherited from the era of central planning.⁵ Vietnam's stabilization program in the early 1990s was pure IMF orthodoxy (albeit without the involvement of the IMF), but the outcome, illustrated in Figure 2, in terms of the rapidity of inflation deceleration and growth acceleration was hardly ordinary. It is doubtful that there is any more successful example of "shock therapy" macroeconomic stabilization.

⁵ Vietnam's sweeping macroeconomic and structural reforms in the late 1980s and early 1990s are described in detail James Riedel and Bruce Comer, "Transition to Market Economy in Viet Nam," in Wing Thye Woo, Stephen Parker and Jeffrey D. Sachs, eds., *Economies in Transition: Comparing Asia and Europe*, Cambridge, MA: MIT Press 1998, 189-216.

Figure 2: Real GDP Growth and the Rate of Change of the GDP deflator: 1991 to 1996
(percentages)



Source: Appendix 1.

Because of fundamental changes in the economy over the past fifteen years, the current rate of inflation, although not nearly as high as in the early 1990s, likely poses a greater threat to the sustainability of growth and certainly involves more difficult policy choices than was the case in the early 1990s. Over the past 15 years, the role of the market has expanded; monetization of economic activity has spread widely; the economy has been opened up to trade and foreign investment; the structure of production and employment has shifted in favor of export-oriented labor-intensive sectors in which Vietnam finds a strong comparative advantage in world markets; private domestic and foreign enterprises have overtaken state-owned enterprises in shares of output and employment; and the financial system has been developed, with the entry of private domestic and foreign commercial banks and the emergence of fledgling stock and bond markets, which have been opened to foreign financial flows. As a result of these changes, key relative prices—the real wage, real exchange rate and the real interest rate, all sensitive to inflation—have much greater influence on resource allocation, income distribution and economic performance than they did in the past. It is unlikely that slashing government expenditures and cutting the rate of credit growth would work the magic they did fifteen years ago.

b. The source of inflation

Inflation is commonly explained in the local and international press by price increases of key commodities. What passes for analysis of inflation is typically something like: “The inflation rate increased last month as a result of a rise in the world price of oil.”⁶ While this approach may appeal to common sense, analytically it leads nowhere. Commodity price increases do not *ipso facto* cause a continuously rising overall price level, which is what properly defines inflation. A rise in commodity prices, such as the recent surge in oil prices, constitutes a negative supply shock which has the effect, if sufficient in magnitude, of raising the overall price level once-and-for-all and leading to a decline in output and employment. Price shocks such as these lead to inflation, properly defined, if and only if the monetary authorities validate them by expanding credit in an effort to avoid their negative effects on output and employment. In this case, the “cause” of inflation is not the commodity price increases *per se*, but instead the monetary response to them. When monetary authorities respond to negative supply shocks by expanding money supply the outcome can be “stagflation,” which was prevalent in the mid 1970s after OPEC quadrupled oil prices and OECD countries struggled to maintain full employment by adopting expansionary monetary policies, but it has not been much in evidence recently in Vietnam, or elsewhere, in spite of significant increases in fuel and food prices in recent years.

Inflation, properly defined, is a monetary phenomenon, simply described by Nobel Laureate Milton Freedman as “too much money chasing too few goods.” The monetary theory of inflation rests on the quantity theory of money, according to which the stock of money is proportional to nominal GDP, as expressed in the following equation:

$$M = k \cdot P \cdot Y$$

where M is the money supply (currency in circulation and deposits in the banking system), P is an index of the overall price level, Y is real GDP, and k is the fraction of nominal GDP ($P \cdot Y$) held as money. If it is assumed that ‘k’ is constant, then the rate of

⁶ For example, see Amy Kazmin, “Vietnam inflation at 12-year high,” *Financial Times* (London), February 28, 2008, p.6.

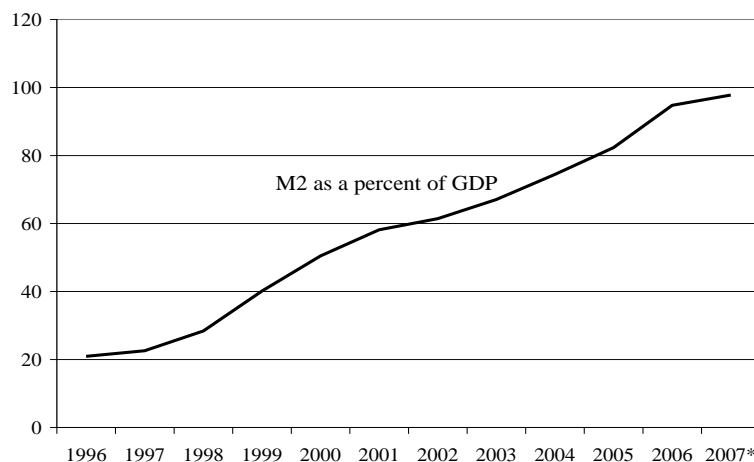
inflation ($\Delta P/P$) is the difference between the rates of growth of money supply ($\Delta M/M$) and real GDP ($\Delta Y/Y$):

$$\frac{\Delta P}{P} = \frac{\Delta M}{M} - \frac{\Delta Y}{Y}$$

In other words, the theory posits that inflation is the difference between the growth rates of money supply and money demand, the former determined by policy and the latter determined by rate of growth of real economic activity.

In a developing transition economy, like Vietnam, it is not reasonable to assume that 'k' is constant. One would expect, in such an economy, that 'k' would rise as transactions are increasingly conducted through monetary exchange rather than through barter or allocation by fiat. Urbanization also leads to a rise in 'k,' since urban residents are likely to conduct a larger proportion of transactions through monetary exchange and have more access to banks than rural ones. Moreover, in financially repressed economies, like Vietnam, rising saving rates lead to a rise in the demand for bank deposits, since households and businesses in financially repressed economies have limited alternatives in which to hold their financial savings. As Figure 3 indicates, the demand for money (mainly bank deposits) in Vietnam has grown much more rapidly than economic activity, the ratio of M2 to GDP rising from 20 percent in 1996 to almost 100 percent of GDP in 2007.

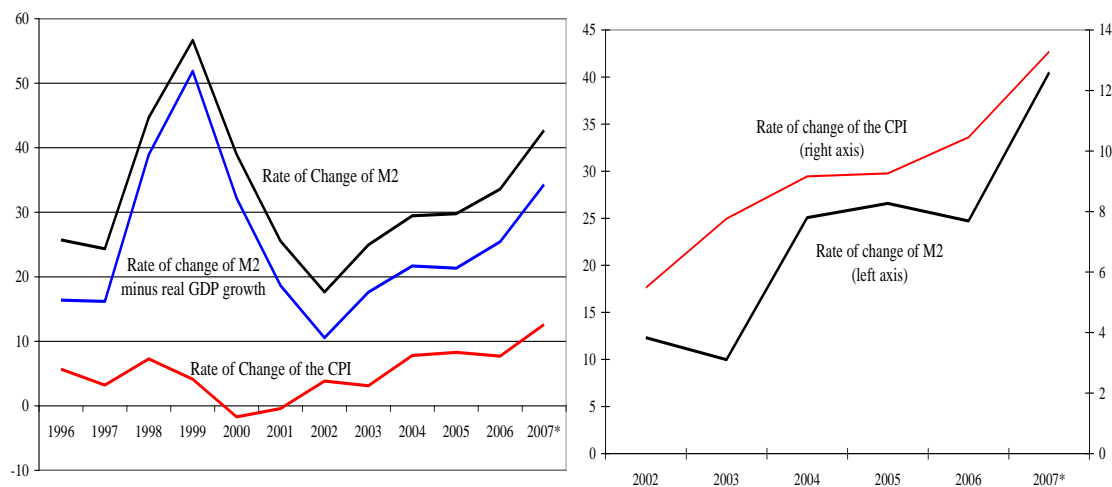
Figure 3: Liquidity (M2) as a Percent of GDP: 1996-2007



Source: See Appendix 1.

In Vietnam, there is a large gap between the rate of money growth and inflation and between the rate of money growth minus real GDP growth and inflation, reflecting the growth of money demand from, *inter alia*, monetization, urbanization and rising saving rates in Vietnam. Nonetheless, it is clear in Figures 4 and 5 that there is a strong positive relation between money growth and inflation in Vietnam. Between 2005 and 2007, the growth rate of M2 increased 43 percent (i.e., from 29 to 43 percent) and over the same period the CPI inflation rate jumped 53 percent (i.e., from 8.3 to 12.7 percent). Inflation is a monetary phenomenon in Vietnam, as it is everywhere else.

Figures 4 and 5: Money Growth and Inflation in Vietnam: 1996-2007
(percentages)

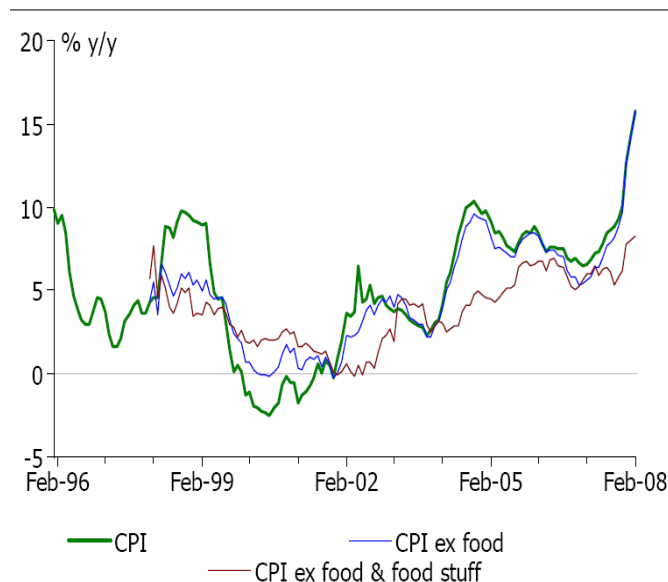


Source: See Appendix 1.

While money supply growth underlies inflation in Vietnam, exogenous prices shocks have no doubt also contributed to the recent rise in the price level. It is useful, therefore, to try to disentangle the relative contributions of demand-side effects from monetary expansion and supply-side effects from exogenous commodity price shocks. This is commonly done by comparing “headline” inflation (the rate of change of the CPI) with an estimate “core” inflation (the rate of change of the CPI, excluding key commodities, for example, oil and food). This approach, it must be recognized, provides only a first-order approximation of the relative contributions of demand- and supply-side factors, since the prices of commodities, like food, are themselves influenced by money-generated demand pressures.

Unfortunately, we do not have adequate data to undertake a reliable estimate of core inflation. There is, however, an available estimate of CPI inflation excluding food, shown in Figure 6, which, according to the author of the report in which this figure appears, indicates that “Vietnam now appears to have a true blue, monetary driven inflation problem.”⁷ This conclusion is supported by the close parallel movement of the rate of change of the CPI and the CPI excluding food.⁸ If, in addition, the effects of oil price increases were taken into account, the core inflation rate would be somewhat lower, though there can be no doubt that it would be found to be accelerating in recent years.

Figure 6: Consumer Price Inflation in Vietnam: February 1996 to February 2008



Source: Duncan Wooldridge, “Vietnam: Inflation Out of the Box,” UBS Investment Research, Asian Economic Comment, February 27, 2008.

⁷ Duncan Wooldridge, “Vietnam: Inflation Out of the Box,” UBS Investment Research, Asian Economic Comment, 27 February 2008.

⁸ It should be noted that there is greater divergence between headline and core inflation when, in addition to food, foodstuffs are excluded from the CPI. The author of the study suggested, however, that the narrower definition of core inflation (excluding only food) is preferable since prices of foodstuffs (e.g. processed foods) are more heavily influenced by demand-side factors. (This is an issue for further research.)

c. Monetary policy

In many countries monetary policy is difficult to discern. Often it is not clear, as is currently the case in the U.S., whether monetary policy is targeting inflation, interest rates or output and employment. In Vietnam monetary policy is (or has been until early 2008) as clear as can be, at least in principle. By choosing *de facto* to peg the domestic currency (dong or VND) to the U.S. dollar, the central bank (State Bank of Vietnam or SBV) has ostensibly chosen the balance of payments as its target.⁹ Under the “rules of the game” of a fixed exchange rate regime, the central bank stands ready to buy (sell) any excess supply (demand) of foreign exchange in the banking system at the pre-announced rate at which the currency is pegged. When the central bank buys up foreign exchange, its official foreign reserves increase and the stock of deposits in the banking system rises; conversely, when the central bank sells foreign exchange to meet an excess demand in the market, reserves go down and the level of deposits in the banking system declines. The assets of the central bank, its official foreign reserves and its domestic currency assets, mainly claims on the central government (treasury bonds) and commercial banks, constitute the base of the money supply and bear a direct relation to the money supply, as is illustrated for Vietnam in Figure 7.¹⁰

In recent years, base money growth has been driven entirely by foreign exchange market intervention, as is illustrated in Figures 7 and 8. From 2000 to 2007, the net foreign assets of the SBV increased by VND290 trillion, while base money increased by VND260 trillion, the difference being a VND30 trillion sell off by the SBV of its domestic currency assets, presumably in an effort to sterilize part of the monetary effect of its massive reserve accumulation (an issue to which we return in the next section). From 2000 to 2005, the inflation rate rose steadily, but remained in single digits (see Figure 1), suggesting that the rapid growth of foreign reserves and base money over this period exceeded, but not excessively, the growth in demand for money. Between 2005

⁹ Vietnam officially defines its exchange rate regime as a closely managed float against a basket of currencies, but in practice the dong has been kept within a narrow band against the dollar.

¹⁰ Money supply (M1 or M2) is a multiple of base money, the multiplier depending on the ratio of currency in circulation to bank deposits and the reserve requirement ratio.

and 2007, however, the doubling of net foreign assets of the SBV was more than could be effectively sterilized and the consequence was a doubling of the inflation rate.

Figure 7: Base Money and M2
(VND billions)

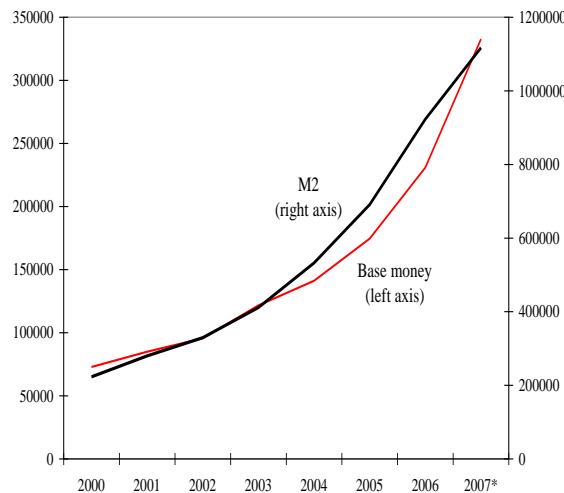
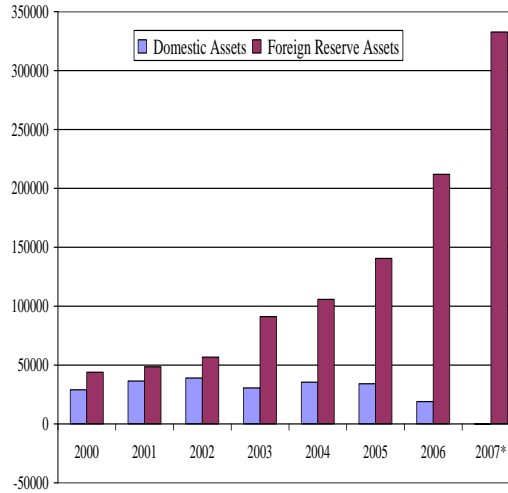


Figure 8: Domestic and Foreign Assets
of the SBV (VND billions)



Source: See appendix 1.

The source of excess foreign exchange absorbed by the SBV in its foreign reserves is revealed in the balance of payments, presented in Table 1. It is readily apparent that the source of the recent build up of foreign reserves was the capital account, not the current account. Remittances from overseas Vietnamese are a major source of foreign exchange, recently amounting to about \$4 billion per annum, but they have been offset by deficits on trade in goods and services and net investment income, such that the current account was in rough balance before 2007. Increases in official reserves, until 2007, closely matched net capital inflows (FDI, ODA and portfolio flows into debt and equity markets). Thus we see that in 2005 and 2006, for example, virtually every dollar entering the country through the capital account was bought up by the SBV and held as foreign reserves. When capital inflows doubled from \$1.9 billion to \$4.1 billion between 2005 and 2006, the increase in reserves doubled correspondingly.

Table 1: The Balance of Payments of Vietnam: 2004-2007
(US\$ Billions)

	2004	2005	2006	2007
Current Account	-1.6	0.2	0.2	-6.4
Goods & Services Balance	-3.2	-2.0	-2.8	-9.0
Investment Income Balance	-0.9	-1.2	-1.4	-1.6
Net Transfers	2.5	3.4	4.4	4.2
Capital Account ¹	2.5	1.9	4.1	15.2
Net FDI	1.9	2.0	2.4	4.0
Other Financial Flows (net) ^{1,2}	0.7	-0.1	1.7	11.2
Change in Reserves ³	-0.9	-2.1	-4.3	-8.8

Notes: 1. Including errors and omissions; 2. Including ODA flows and debt and equity portfolio flows; 3. Negative indicates an increase in official reserve assets
Sources: See Appendix 1.

In 2007, the pattern of external payments of recent years was ruptured with a three-fold increase in the trade deficit (bringing it to an equivalent of about 13 percent of GDP) and an almost four-fold increase in net capital inflows (to a level equivalent to 20 percent of GDP). The dramatic rise in the trade deficit and the emergence of a significant current account deficit offset about 40 percent of net capital inflows. After financing the current account deficit, the SBV was left with the remaining \$8.8 billion (equivalent to 12.5 percent of GDP) to buy up and add to foreign reserves to prevent a precipitous appreciation of the dong.

Given our focus on foreign exchange supply, we have not distinguished between the various forms of capital flows. All of them—FDI, ODA and portfolio flows into asset markets—contribute to the overall supply of foreign exchange in the system. They differ significantly, however, in terms of their relative riskiness. The risk of an abrupt reversal of flows is not great for FDI and ODA, but portfolio flows into equity and debt markets are notoriously fickle. In recent years, net FDI has been running at about \$2 billion, though it increased significantly in 2007, perhaps in response to Vietnam's

accession to the WTO in January of that year.¹¹ ODA flows are fairly steady at about \$1.3 billion.¹² It was not until 2006 and 2007 that large amounts of short-term capital began to flood into Vietnam, which in 2007 amounted to as much as \$10 billion (equivalent to almost 15 percent of GDP). In 2006, an inducement to the inflow of short-term capital was a boom in the stock market, which saw prices double in the second half of the year. More recently, with stock prices falling in 2007, a mounting expectation of appreciation of the dong has been the main attraction, leading to massive flows of “carry trade”, a financial industry euphemism for exchange rate speculation. As a Vietnam investment fund explains it, “International investors can lock in a USD [interest rate] spread of close to 600 bps (6 percentage points), in a currency which is obviously on an appreciating track.”¹³ It is reported that foreign investors have come to dominate trading in the primary and secondary markets for government debt, accounting for 95 percent of total trading, with a volume in March 2008 of about \$40 million per day, double the volume in the previous year.¹⁴

d. Policy choices and the “rules of the game”

It was noted above that Vietnam’s decision to peg the dong to the dollar constituted a monetary policy dedicated to clearing the foreign exchange market at the exchange rate set by the central bank, which until 2008 was allowed to depreciate against the dollar at about one percent per year, possibly to counter the inflation differential with the United States. Following the “rules of the game” of a pegged exchange rate regime, if market conditions require the central bank to intervene, buying or selling foreign reserves, expanding or contracting money supply, pushing up or down the interest rate and inflation, then so be it. The inflation and interest rate consequences of exchange

¹¹ For an account of trade flows in Vietnam after the first nine months of WTO accession, see the report: *2007 Trade Update for Vietnam After Nine Months of WTO Accession*, prepared by the MPI’s Central Institute of Economic Management and STAR-Vietnam, February 2008.

¹² See Appendix 1.

¹³ Dragon Capital, Vietnam Focus, February/March 2008. Note: The yield on U.S. 2-year Treasury bonds currently is 2.4 percent (<http://Bloomberg.com/markets/rates>), while on Vietnam government bonds (as of March 2008) it was 8.7 percent (HSBC, Vietnam Focus, 10 March 2008).

¹⁴ Dragon Capital, op. cit.

market intervention are the essential mechanism by which equilibrium in the foreign exchange market is restored and maintained in a fixed-rate regime. Without such adjustments, the disequilibrium that forces the central bank to intervene in the first place persists and worsens until the central bank is forced to abandon the regime. That is why a fixed exchange rate and an independent monetary policy, in the presence of capital mobility, are incompatible. This fundamental principle of monetary economics—the incompatibility of a fixed exchange rate, an independent monetary policy and free capital mobility—is what is often referred to as the “impossible trinity.”

The impossible trinity suggests that Vietnam must choose, in the current situation, either to accept accelerating inflation, let the exchange rate appreciate, or restrict the inflows of capital that are the source of the imbalance. It is apparent, however, that Vietnam wants it all ways and so has chosen *not* to conduct its policy according to the rules of a fixed rate regime. It has chosen to avoid the impossible trinity by attempting to sterilize (nullify the monetary consequences) of the central bank foreign exchange interventions. The most direct way of doing this is by the central bank simultaneously selling its domestic assets while buying foreign exchange, which as Figure 8 above indicates the SBV has done on a modest scale since 2002. Having depleted its domestic currency assets by 2007, the central bank has since been compelling commercial banks to buy government debt in order to mop up liquidity created by foreign exchange purchases.¹⁵ Another way in which the SBV has practiced sterilization is by raising the reserve requirement ratio, which it doubled to 10 percent of bank deposits in June 2007, adding another one percent in February 2008.¹⁶ In addition, interest rates have been capped and ceilings have been imposed on the growth of commercial bank credit.¹⁷

Sterilization by traditional means (simultaneously selling domestic assets while buying foreign exchange) is costly to the SBV since there is that six percentage point spread between U.S. and Vietnamese interest rates that is attracting exchange rate

¹⁵ Amy Kazmin, “Vietnam in the grip of cash crunch,” *Financial Times* (London), February 27, 2008, p.8.

¹⁶ Dragon Capital, *Vietnam Focus*, April 2008, p. 9.

¹⁷ Credit Suisse, Emerging Markets Economics Research, 13 March, 2008 and Dragon Capital, *Vietnam Focus*, April 2008.

speculators to Vietnam.¹⁸ Raising reserve requirements, capping interest rates and restricting credit growth are no less costly, but shift the cost from the central bank to commercial banks. In late 2007, the central bank reportedly curbed its purchases of dollars, refusing to accommodate commercial banks seeking to offload their dollar holdings.¹⁹ Since commercial banks are restricted from selling dollars outside the official trading band, commercial banks began to curb their own purchases of dollars, making it difficult for Vietnamese exporters to convert dollar revenues into the local currency they need to cover wage and other production costs.²⁰ Not surprisingly, the surplus of dollars and shortage of dong in the banking system pushed the official exchange rate (VND/\$) to the floor of the official trading band and led to the reemergence of a black market in which the dollar, in March 2008, was reported to be selling about 3 percent below the official rate.²¹

What is the government to do? Act in the best interests of the nation, of course. As is inevitably the case in economics, however, the interests of the nation are divided. Those who are invested in stock, bond and real estate markets naturally favor a more flexible exchange rate.²² Floating the exchange rate would allow the central bank to ease the domestic currency credit-crunch that has pricked the price bubbles in stock and real estate markets. In addition, an appreciation of the currency would validate the expectations of foreign investors and speculators in the stock, bond and real estate markets, encouraging perhaps even larger portfolio flows to Vietnam, potentially pushing asset prices even higher.

Those who earn their income in the tradable goods sector—manufacturing and agriculture—no doubt oppose a significant revaluation or a floating of the exchange rate

¹⁸ Speculation is a zero-sum game, so the gains (loses) of exchange rate speculators are matched by the losses (gains) of the central bank.

¹⁹ Amy Kazmin, “Vietnam in the grip of cash crunch,” *Financial Times* (London), February 27, 2008, p. 8.

²⁰ Ibid.

²¹ James Hookway, “Vietnam Tries to Cut Loose From Dollar: Unlinking Currency May Curb Inflation But Irks Exporters,” *Wall Street Journal*, March 19, 2008, p. A8.

²² See recent analyses by HSBC, Credit Suisse and Dragon Capital.

out of fear that a significant nominal appreciation of the currency could undermine the country's international price competitiveness and cause losses of output and employment.

Competing interests are likely united, however, in their opposition to inflation. Those in the financial sector presumably recognize that accelerating inflation could further destabilize asset markets; those in the tradable goods sector must be aware that inflation is as much a threat to international price competitiveness as nominal appreciation; no doubt the government, too, fears inflation more than the alternatives, since it has the potential to unleash social unrest and cause political instability. Given the apparent inability of the SBV to sterilize effectively large purchases of foreign exchange, the policy choice facing the government seems to come down to either abandoning the *de facto* peg to the dollar or restricting capital flows. Playing by the rules of a fixed exchange rate regime—accepting the inflationary consequences of large capital inflows—is presumably unacceptable to all parties.

As of March 2008, indications were that the government was more disposed toward exchange rate adjustment than restricting capital inflows. Widening the official exchange rate trading band and curbing the purchase of excess dollars in the banking system are clear indications that the authorities are prepared to allow exchange rate to adjust, if not float freely. In discussions with investment bankers, Vietnamese authorities have revealed that they are doubtful that capital controls can be effective and fear that imposing them could undermine asset markets and create a long-lasting loss of investor confidence.²³

The government's apparent stance on the relative merits of exchange rate flexibility versus capital controls is supported by the IMF, which in August 2007 issued a sanguine assessment of Vietnam's prospects, noting that "Overall macroeconomic performance remains strong."²⁴ In spite of trade and current deficits at 13 and 9 percent of GDP respectively in 2007, the view of the IMF was that "Vietnam's balance of payments is basically sound." The IMF further noted that "This is a propitious time for a move toward a more flexible exchange rate regime."²⁵ The IMF could find no case for

²³ HSBC, "Vietnam Economics: Too many targets," Global Research, 13 July 2007.

²⁴ IMF, Vietnam: Staff Report for the 2007 Article IV Consultation, August 28, 2007, p. 3.

controls on capital inflows, which in 2007 amounted to about 20 percent of GDP, and was of the opinion that “Capital inflows have contributed to a decline in domestic-currency bond yields and a boom in the stock market, boding well for the financing of Vietnam’s investment needs.”²⁶

2. Lessons from China

If the sanguine views of the IMF on the current macroeconomic situation in general and the merits of a more flexible exchange rate in particular are informed by the experience of other countries, then it is likely the recent experience of China and not those of Thailand or Indonesia in the 1990s that the IMF has in mind. The macroeconomic challenges facing Vietnam are in some respects similar to those that China handled successfully in recent years. What then are the lessons Vietnam may draw from China’s recent experience?

a. Similarities and differences

Like Vietnam, China maintains a *de facto* pegged exchange rate. From 1997 to July 2005, the rate was virtually constant at 8.3 RMB/\$. On July 21, 2005, the RMB was revalued by 2 percent. In 2006, the RMB rose against the dollar another 4 percent and in 2007 by yet another 6 percent. The year-end RMB/\$ rate for 2008 is expected to be around 6.8 RMB per dollar, which would constitute a nominal appreciation of 8 percent from 2007 and 18 percent from July 2005 when the authorities began to adjust the exchange rate.²⁷

Even though Chinese authorities have revalued the RMB significantly, the currency remains pegged at a rate above the market-clearing level. Evidence that the RMB is significantly above its market clearing level is given by the growing accumulation of reserves by the central bank (People’s Bank of China, PBC) over the past seven years. As Figure 9 indicates, China has been successful at sterilizing reserve

²⁵ *Ibid.*, p. 14.

²⁶ *Ibid.*, p. 4.

²⁷ UBS, China by the Numbers (March 2008).

accumulations, maintaining the growth of base money at a steady rate of about 10 percent per annum, in line with the growth of real economic activity. In Vietnam, by comparison, base money, fueled by foreign reserve accumulation, grew at an accelerating rate, averaging 26 percent per annum over the same period. Not surprisingly, as shown in Figure 10, the inflation rate in Vietnam has exceeded China's by a large and expanding differential (8 percentage points in 2007). Since China and Vietnam face essentially the same exogenous commodity price shocks, the inflation differential between the two countries underscores the importance of monetary factors underlying the recent acceleration of inflation in Vietnam.²⁸ Money growth and inflation are closely related in China also, but China has been more successful at keeping money supply and demand growth in balance through effective sterilization of foreign exchange market intervention.²⁹

Figure 9: The Rate of Growth of Base Money and Its Components in China: 2001-2007(percentages)

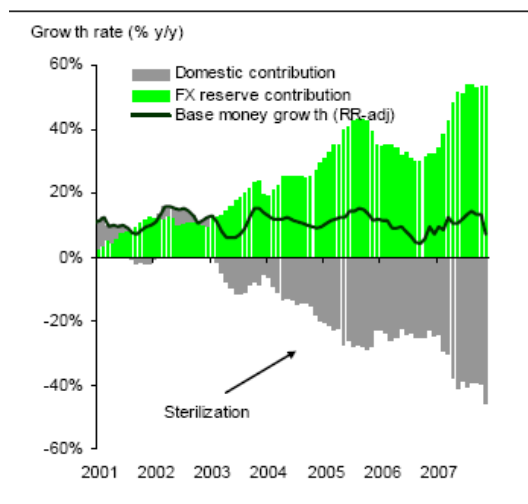
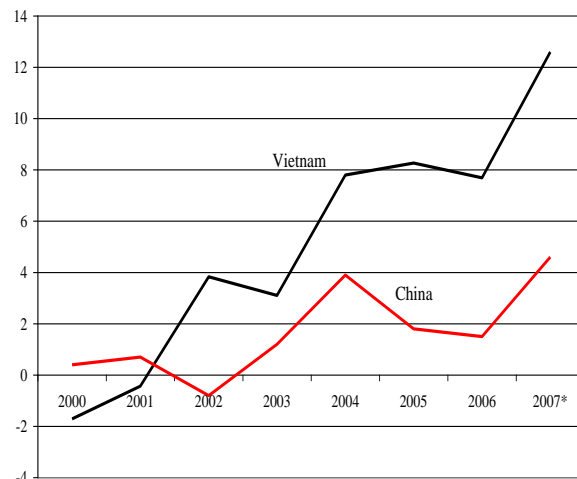


Figure 10: The Rate of Change of the CPI in Vietnam and China: 2000-2007 (percentages)



Source: Jonathan Anderson, "The China Inflation Primer," UBS Investment Research, Asian Economic Perspective, March 5, 2008, p. 21 and Appendix 1.

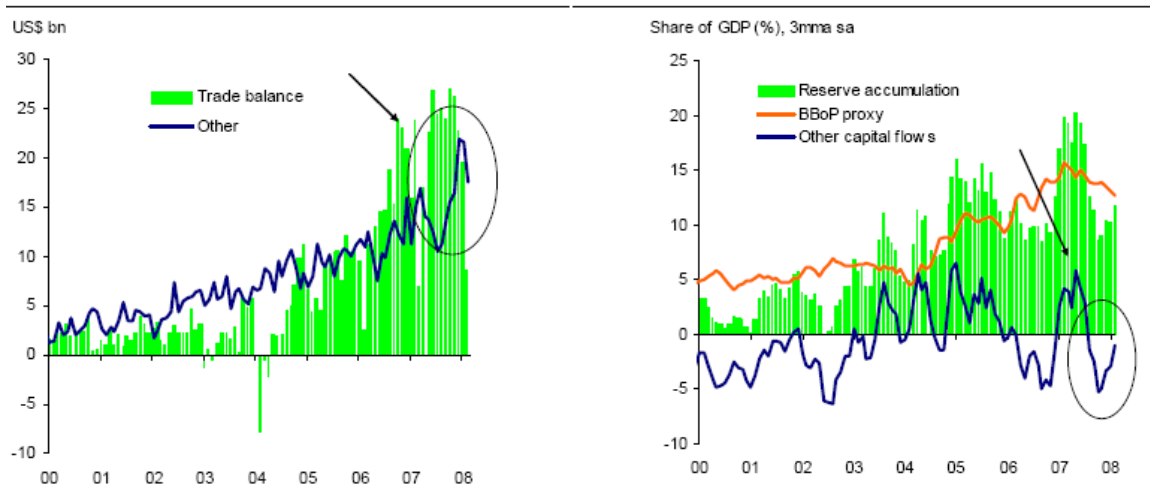
²⁸ In January 2008, China experienced a sharp rise in the CPI (7 percent, year-on-year), which is attributable to severe winter snowstorms. CPI inflation is expected to be down to about 3 percent by the end of the year. Jonathan Anderson, "The China Inflation Primer," UBS Investment Research, Asian Economic Perspective, 5 March 2008, p.3.

²⁹ Riedel, et. al., (2007), *op. cit.* Chapter 8.

The sources of the excess foreign exchange that the central banks of China and Vietnam must absorb to keep their exchange rates pegged are substantially different in the two countries. In Vietnam, as discussed above, it is the capital account, and in the past year portfolio flows in particular, that have been the overwhelming source of excess foreign exchange supply, while in China, as Figures 11 and 12 indicate, it is the current account surplus and FDI inflows that are the main sources. Figure 11 (columns) shows that China has had a growing trade surplus every year since 2000. The solid line is the balance of all other current account items plus net FDI. The sum of the two series (trade balance and “other” in Figure 11) is the so-called “basic balance” of the balance of payment (i.e., the sum of the current account balance and net FDI).

Figure 11: Components of the “Basic Balance” of the Balance of Payments in China: 2000-2007 (US\$ billions)

Figure 12: The “Basic Balance,” Net Portfolio Capital Flows and Change in Reserves as a % of GDP in China



Source: Figure 10: Jonathan Anderson, “Whoops – Is \$60 Billion a Lot? (Revised),” UBS Investment Research, China Focus, 31 March 2008, p.4; Figure 11: Appendix 1.

Below the basic balance are net portfolio flows (sometimes referred to as “hot money”) and changes in reserves. Figure 12, which plots the basic balance (“BBoP”), portfolio flows (“Other capital flows”) and reserve accumulation, indicates that trade surpluses and net FDI have provided most of the foreign exchange accumulated by the PBC. From 2000 to 2003, portfolio capital flowed out of China and then reversed

direction when expectations of an RMB revaluation began to strengthen in 2004. In no year did portfolio flows in or out of China as a percent of GDP come near to the 15 percent of GDP estimated for Vietnam in 2007, which suggests that China has taken a more cautious approach to opening its capital account than has Vietnam.

b. Lessons

It is clear from the above that China's ability to meet the macroeconomic challenges of a pegged exchange regime does not offer many comforting lessons for Vietnam. Both countries peg their exchange rate above market clearing levels and are therefore obliged to accumulate reserves, but China has so far been far more successful at sterilization than Vietnam and so has avoided the kind of inflation that currently threatens Vietnam's growth prospects. We can only conjecture as to why China is better able to sterilize. Perhaps, because Chinese banks are larger and their balance sheets are stronger, they are better able to absorb the central bank and government debt that sterilization requires, avoiding the kind of domestic currency credit-crunch that afflicted Vietnam the past year. In addition, domestic interest rates and the spread on dollar rates are lower in China, which means that the cost of sterilization is lower than in Vietnam.³⁰ Whatever the reason (and it certainly merits more research), it is clear that Vietnam's pegged exchange rate is much more vulnerable than China's.

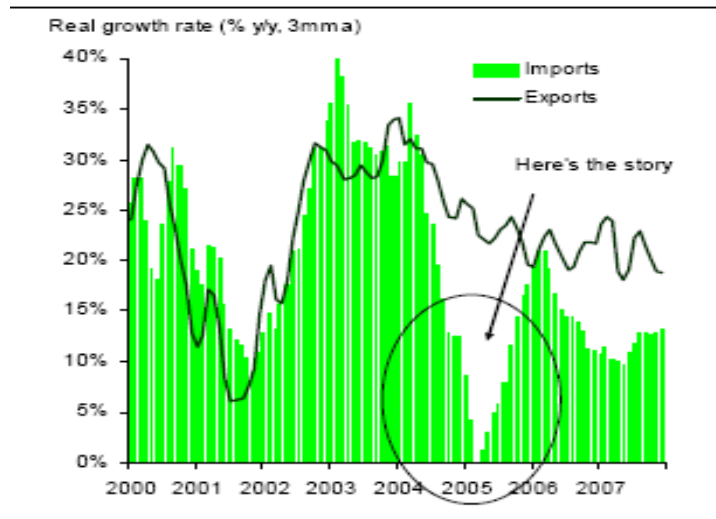
It might be argued that China's peg is stronger than Vietnam's because China has been revaluing its currency the past three years and in so doing has lessened the need for sterilized intervention. That is a reasonable proposition in theory, but it is not supported by the data. Revaluation, in theory, lessens the pressure for intervention by lowering trade and current account balances and reducing the incentive for speculative capital inflows. As we observed in Figures 11 and 12, however, China's trade and basic balances have been rising, not falling, and speculative inflows have played a relatively small role. As a result, the pressure for sterilized intervention in China is growing, not diminishing, in spite of a significant appreciation of the currency. If China's experience is relevant, it suggests that since Vietnam is already encountering problems sterilizing foreign exchange interventions, nothing short of a free float may be likely to lessen

³⁰ The money market interest rate in China in 2007 was 2.6 percent, close to the rate in the United States. In Vietnam the comparable rate was 8.8 percent. UBS, *China by the Numbers (March 2008)*, p. 25.

monetary pressure on inflation. Gradualism, the hallmark of China's approach, has worked in China because, so far, it has not been constrained in its ability to sterilize reserve accumulations.

The fact that China's trade surplus expanded at the same time its currency was appreciating might suggest that Vietnam's exporters should not feel threatened by the prospect of a revaluation or even a free float. Unfortunately, if we look at the factors behind China's rising trade balance since 2005, we find no support for this proposition. As Figure 13 indicates, the growth rate of exports in China has been declining steadily since 2004, whether as a result of real appreciation or other factors we cannot say (another key issue that deserves further research). In any case, as Figure 13 indicates, the dramatic rise in China's trade balance is entirely due to a precipitous drop in imports in 2004 and 2005. The decline in imports was primarily in heavy industrial goods (e.g., steel) and occurred mainly because of excess capacity built up in the previous two or three years as a result of an increase in government-directed credit to SOE-dominated heavy industries in an effort by the government to spur growth at a time the economy was supposedly "cooling down."³¹ Vietnam can not, therefore, take comfort from the fact that China's revaluation was accompanied by a rise rather than a fall in the trade balance.

Figure 13: The Rate of Growth of Exports and Imports in China: 2000 to 2007



Source: Jonathan Anderson, "How to Think About China, Part 5, All about rebalancing," UBS Investment Research, Asian Economic Perspectives, March 26, 2008, p. 10.

³¹ For the full story, see Jonathan Anderson, "How to Think About China, Part 5, All about rebalancing," UBS Investment Research, Asian Economic Perspectives, 26 March 2008.

A sustained real appreciation ultimately requires a fundamental restructuring of an economy. A real appreciation implies a rise in the relative price of non-tradable goods and services and leads to a movement of labor and capital from manufacturing and agriculture and toward services and other non-tradable goods sectors. The restructuring of the production side of the economy requires a commensurate restructuring on the demand side. With a permanent real appreciation, the current account balance is expected to decline together with its counterpart, the domestic saving-investment balance—in other words, the domestic saving rate is expected to fall and the share of consumption in GDP is expected to rise. Foreign critics of China's economic policy have been urging China to restructure its economy along these lines and, indeed, China has set the process in motion, though perhaps more gradually than its critics would like. Nevertheless, if China persists with its policy of step-by-step revaluation and ultimately floats the exchange rate, these changes in the structure of production and expenditure will inevitably occur, as they have in other countries in the region (e.g. Japan and the East Asian NICs) after decades of sustained growth.

It is apparent, for a number of compelling reasons, that the kind of structural changes that China is (or certainly will) undertake as its currency appreciates over time are not appropriate for Vietnam at its earlier stage of development. First and foremost, in terms of per capita income, China is about 15 years ahead of Vietnam.³² China is far more industrialized and its industrial base is more diversified than Vietnam's. China is far less dependent on trade, with an export-GDP ratio half that of Vietnam. Household and corporate saving rates in China are almost double those in Vietnam, which implies that a rebalancing between consumption and saving is more compelling and likely to have more favorable outcomes in China than in Vietnam. The "middle class" plays a larger role in China's economy and its real income is growing more rapidly than in Vietnam, which suggests that resources released from the tradable goods sector as a result of a permanent real appreciation can be more readily absorbed in the non-tradable sector at a lower adjustment cost than would likely be the case in Vietnam.

³² At a 7 percent per annum rate of growth of per capita income, it will take Vietnam 15 years to reach China's current per capita income (\$2200). ADB, Key Indicators 2007 (<http://www.adb.org/statistics>)

It should be noted that a secular rebalancing from tradables to non-tradables is associated empirically with a decline in the long-run rate of growth because productivity growth in the expanding non-tradable goods sector is typically lower than in the declining tradable goods sector.³³ This outcome is a natural and, indeed, desirable consequence of decades of successful economic development. A shift of resources from tradables to non-tradables and a resulting decline in the rate of growth is not desirable, however, if it is forced to happen before its time. China, which is a decade and a half ahead of Vietnam, is only just beginning this process. Vietnam will eventually get there if it can sustain the current high rate of growth by continuing to exploit its comparative advantage in relatively labor-intensive manufacturing, which for the time being requires that it vigilantly protect its international price competitiveness

3. Assessing Policy Options

a. Exchange rate policy

The current situation in Vietnam is unlike that in most countries that have abandoned a fixed exchange rate under pressure. The most common case (e.g., the Asian financial crisis countries) is one in which there are large trade and current account deficits and capital flight, forcing the central bank to sell off its reserves, contract money supply and raise interest rates. Devaluing the currency works to correct the trade and current account deficits, relieves the hemorrhaging of reserves and eases conditions in the domestic credit market. The China case, much rarer, is the exact opposite. In both cases a change in the exchange rate regime is an obvious policy choice. The current situation in Vietnam, however, is a combination of the worst of both cases—large trade and current account deficits, which demand, if not depreciation, a tight hold on the exchange rate peg, and, at the same time, rapidly growing reserves and rising inflation, which make a strong argument for revaluing the currency or adopting a free float. Clearly, Vietnam cannot do both, so perhaps it should do neither.

³³ Empirical evidence is provided in William D. Nordhaus, “Baumol’s Diseases: A Macroeconomic Perspective,” *The B.E. Journal of Macroeconomics*, Vol. 6, Iss. 1, 2008, Article 9. (www.bepress.com/bejm/vol8/iis1/art9)

b. Fiscal policy

If Vietnam chooses to retain its peg to the dollar, the scope for an independent monetary policy is limited, given the difficulties the country has encountered trying to sterilize reserve accumulations. What then is the potential role for fiscal policy? In the early 1990s, fiscal policy was the key to macroeconomic stabilization, since it was fiscal deficits arising largely from the withdrawal of Soviet transfers and the financing of SOE financial losses that drove the rapid growth of credit and soaring inflation rate. In the current situation, however, it is the accumulation of foreign reserves caused by large inflows of foreign capital that is driving monetary expansion and inflation. Since fiscal policy is not the main source of the current problem, it is not reasonable to expect it to be a major part of the solution.

Fiscal policy can, however, play a supporting role. In the current situation, a fiscal contraction in the form of an increase in taxes and/or decrease in government spending could ameliorate the current imbalance by reducing aggregate demand and lowering interest rates. A reduction in aggregate demand would potentially serve to reduce trade and current account deficits and ease inflationary pressure. A decline in interest rates, on the other hand, could potentially lessen the incentive for the short-term capital inflows that have been a major source of the recent accumulation of reserves.

Unfortunately, the government's current and projected fiscal stance is at cross purposes with what is required to ameliorate the internal and external imbalances that are threatening growth and stability. Vietnam's official budget deficit and overall fiscal deficit (including off-budget expenditures), shown in Table 2, increased about three percentage points of GDP in 2007 and are not expected to decline appreciably in 2008. The government's commitments to lower tariffs following WTO accession, align corporate income tax rates with those of regional competitors, raise public sector wages, strengthen the pension system, and increase much-needed investment in physical and social (e.g. health and education) infrastructure will make it quite difficult to undertake a major fiscal contraction aimed at reducing aggregate domestic demand.³⁴

³⁴ IMF, Staff Report for the 2007 Article IV Consultation, August 28, 2007, p.17.

Table 2: Vietnam Fiscal Balances as a Percent of GDP: 2004 to 2008

	2004	2005	2006	2007P	2008P
Official budget balance	0.9	-1.2	-0.3	-3.4	-2.1
Off-budget expenditure & net lending	3.7	4.7	3.5	3.5	4.5
Overall fiscal balance	-2.8	-5.9	-3.8	-6.9	-6.6
Non-oil overall fiscal balance	-10.7	-14.6	-13.5	-14.8	-14.5

Note: Data for 2007 and 2008 are projections.

Source: IMF, Staff Report for the 2007 Article IV Consultation, August 28, 2007, p.24.

c. Capital controls

Limitations on the scope and potential effectiveness of monetary and fiscal policy in dealing with Vietnam's current crisis require that consideration be given to capital controls. No one would suggest that all foreign capital inflows be controlled, nor would all foreign investors necessarily favor currency appreciation over selective capital controls. Foreign direct investors on whom Vietnam relies heavily for capital, technology and know-how have a strong stake in Vietnam's international price competitiveness. Foreign investors in Vietnam's financial and real estate markets, on the other hand, are vocally opposed to any form of capital control and believe, so their published reports suggest, that their interests would be served by currency appreciation. It is quite possible, however, that foreign financial investors are mistaken in their belief that appreciation is in their interest. It is unlikely that asset prices would continue to rise, and indeed would not eventually fall, if trade and current account deficits, already high, were to increase substantially and the real side of the economy were to go into decline, both of which are entirely possible if Vietnam were to suffer a significant loss of price competitiveness. When the real and financial sides of an economy get out of balance, as in the U.S. at the end of the "dotcom" boom in the 1990s and at the end of the recent real estate price bubble, financial markets are the biggest losers. It could be reasonably argued, therefore, that investors in Vietnam's financial markets have as much to lose from a currency appreciation as anyone.

What kind of capital controls might be appropriate in Vietnam's current circumstances? Without more detailed data on capital flows and qualitative information

about the workings of Vietnam's financial markets, it is difficult to suggest anything other than a guiding principle, which in a nutshell is that, if capital controls are adopted, they should be designed to target narrowly the inflows that are the principal source of the current imbalance, which are mainly those arising from exchange rate speculation.

d. The Thai experiment

The most recent experiment with controls on capital inflows is that of Thailand. In 2006, the combination of a strong trade balance, large inflows of FDI and growing portfolio capital inflows pushed the baht up 16 percent and pressured the Bank of Thailand to undertake sterilized intervention to avoid an even greater baht appreciation.³⁵ With domestic interest rates at relatively high levels, sterilization became increasingly costly, leading the Bank of Thailand to take measures "to prevent speculative pressure on the Thai baht."³⁶ The measure taken, on December 18, 2006, was the imposition of a tax on foreign portfolio inflows in the form of a 30 percent unremunerated reserve requirement on short-term capital inflows. The following day the Thai stock market fell 15 percent, prompting the Bank of Thailand to immediately remove controls on foreign investment in the stock market. Controls on foreign investment in the bond market were retained, with assurances from the Bank of Thailand Governor, Tarisa Watanagase, that they would likely be lifted in three to six months.³⁷ It was not, however, until March 2008, after a new government had been voted into power two months earlier, that the controls on foreign investment in Thailand's bond market were lifted.³⁸

Did Thai capital controls work? An answer to that question is problematic because it depends on what is meant by "work." If the question is, did they curb foreign capital inflows to the bond market, the answer is affirmative. As Table 3 indicates, in the first half of 2007, after the controls were imposed, there was a significant net capital outflow in debt securities. It is reported that bond trading by non-residents fell from a

³⁵ Jonathan Anderson, "The Strange Case of Thai Capital Controls," UBS Investment Research, Asian Focus, 19 December 2006.

³⁶ This quote is from the December 18, 2006 Bank of Thailand press release (<http://www.bot.or.th>)

³⁷ Phisanu Phromchanya, "Thailand defends controversial capital controls," *The Wall Street Journal*, December 27, 2006, p. B5.

³⁸ "Dumping the reserve clause clears the air," *The Nation* (Thailand), March 10, 2008.

daily average of baht 2.8 billion in 2006 to baht 600 million in 2007 and that on the first day the controls were lifted, in March 2008, the volume of foreign trading in the bond market doubled.³⁹

Table 3: Balance of Payments of Thailand: July 2006 to December 2007
(US dollars billions)

	2 nd Half of 2006	1 st Half of 2007	2 nd Half of 2007
Current Account	3.8	5.8	9.1
Capital Account	4.3	-0.1	2.3
Net FDI	2.7	4.4	3.4
Net Portfolio	1.6	-4.6	-1.1
Equity Securities	2.1	3.6	0.9
Debt Securities	0.3	-1.7	0.3
Other Portfolio	-0.7	-6.4	-2.2
Change in Reserves	-8.1	-5.7	-11.4

Note: Other portfolio includes errors and omissions.

Source: Bank of Thailand website (<http://www.bot.or.th>).

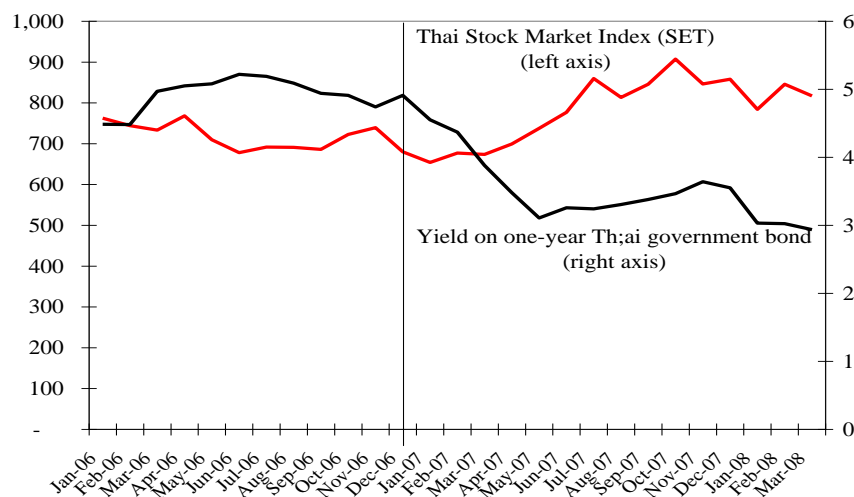
If the question is, did the controls relieve pressure on the Bank of Thailand to purchase foreign reserve assets and prevent an appreciation of the baht, the answer is negative. Although the increase in reserves in the first half of 2007 was US\$ 2.4 billion lower than in the second half of 2006, the increase in the second half of 2007 was US\$ 3.3 billion higher. Moreover, by March 2008 the baht was about 15 percent higher against the dollar than at the end of 2006. It is hardly surprising that the controls on capital inflows to the bond market had little effect on the foreign exchange market, since, as Table 3 indicates, they were not an important source of excess foreign exchange in the first place. In Thailand, as in China, the main sources of excess foreign exchange supply were the current account and foreign direct investment, which raises a question as to why the Bank of Thailand chose to impose controls on portfolio capital flows in the first place.

While Thailand's experiment with capital controls does not appear to have achieved its intended objectives, neither does it appear to have done much harm. As Figure 14 indicates, after controls on capital flows to the equities market were lifted a day after being imposed, the market rebounded from its one-day decline of 15 percent and by March 2008 stood 20 percent higher than before the controls were announced in

³⁹ "Scrapping of Controls: Will investors come back?" *The Nation* (Thailand), March 7, 2008.

December 2006. Furthermore, the controls on inflows to the bond market, in place for more than a year, also do not appear to have any significant effect on the bond market, as the yield on government bonds declined significantly in 2007 in spite of the controls. It is worth noting that even though Thailand's capital controls do not appear to have had much effect, Thai business groups (including the Federation of Thai Industries and the Thai Chamber of Commerce) insist that the controls either be reinstated or alternative measures be taken to halt the appreciation of the baht.⁴⁰

Figure 14: Thai Stock Market Index and Government Bond Yield (%)



Source: Bank of Thailand website (<http://www.bot.go.th>).

Thailand's recent experiment with capital controls offers little guidance for Vietnam in confronting its current macroeconomic dilemma. When Thailand imposed capital controls at the end of 2006 it had large surpluses on trade and current account, while Vietnam currently has deficits in both accounts that are larger, relative to GDP, than Thailand's surpluses. In Thailand, the main sources of excess foreign exchange were the trade surplus and net foreign direct investment, while in Vietnam the main source is portfolio flows in general and speculative flows in particular. Controls on the inflows of portfolio capital did not work in Thailand to relieve the pressure for reserves accumulation and currency appreciation because, if for no other reason, they were not the

⁴⁰ "Government urged to review its decision," *The Nation* (Thailand), March 4, 2008.

main cause of the problem they were intended to solve. Capital controls do not appear to have adversely affected financial markets in Thailand, but it appears that was primarily because the controls on flows into the equity market were immediately lifted and in the bond market the foreign inflows were small relative to the size market.

In Vietnam, controls on speculative capital inflows have a greater potential to ease the pressure on reserve accumulation and currency appreciation, provided that they are not diverted to FDI or other flows in an effort to avoid the controls. By the same token, capital controls have a greater potential in Vietnam to lower stock prices and raise interest rates, raising the cost of capital and potentially adversely impacting investment (another issue that should deserves more research). Thailand's experience with capital controls does not suggest that capital controls should be ruled out as a policy option in Vietnam, but it does suggest that the authorities in Vietnam should weigh this option carefully and, if they should decide to use capital controls, they should be targeted as narrowly as possible on those flows that are the principal source of the problem.

e. The Malaysia experiment

Another Southeast Asian country to experiment with capital controls is Malaysia, but on outflows rather than inflows. On September 1, 1998, in the midst of the Asian financial crisis, Malaysia imposed controls on capital outflows to reduce speculative pressure against the ringit. The controls do seem to have worked to segment Malaysian financial markets, as interest rates came down and the pressure on the ringit was eased after the controls were put in place.⁴¹ Whether or not they worked to allow a faster recovery from the crisis than would have been possible otherwise is subject to debate, with the weight of opinion being that the effect of the controls, whether net positive or negative, was not big enough to make much difference to the outcome.⁴²

The Malaysia experience, like Thailand's, is not particularly relevant to Vietnam's current situation. Malaysia imposed controls on capital outflows in the midst

⁴¹ Ethan Kaplan and Dani Rodrik, "Did the Malaysian Capital Controls Work?" in S. Edwards and J. Frenkel, eds., *Preventing Currency Crises in Emerging Markets*, University of Chicago Press for the NBER, 2002.

⁴² W. Max Corden, "The Asian Crisis: A Perspective after Ten Years," *Asian-Pacific Economic Literature*, Vol.21, No 2, November 2007. Also see, Premachandra Athukorala, *Crisis and Recovery in Malaysia: the role of capital controls*, Edward Elgar, Cheltenham, 2001.

of a crisis; in Vietnam controls should be considered on capital inflows principally to avoid a crisis. As has been noted, "...the use of capital controls on outflows as a crisis-resolution measure remains highly controversial," whereas "There has been increasing acceptance in recent years of capital controls on inflows as a prudential measure aimed at preventing a build-up of short-term liabilities, particularly in lower-income countries that do not have the capacity to put in place sophisticated financial supervisory regimes."⁴³ A widely held view is that "premature capital account liberalization, initiated before the development of domestic financial markets is sufficiently advanced, can be dangerous and counterproductive."⁴⁴ Possibly Vietnam's current predicament is, therefore, a consequence of a premature opening up of its financial markets. Even if it could be demonstrated that this is indeed the case, it would not necessarily follow that its financial markets should be closed to foreign capital. If Vietnam can contain the speculative capital flows that are causing the current predicament and avoid taking measures that would weaken the foundation for long-term growth, it can get on with the all-important task of building a financial system that can withstand the vicissitudes of financial globalization.

4. Conclusion

Vietnam is sailing in un-chartered waters. Few countries, if any, have experienced capital inflows sufficient in magnitude to finance a current account deficit and an increase in foreign reserves, each as large as about 10 percent of GDP. That is why the experiences of other countries that have been considered here—China, Thailand and Malaysia—contain few lessons that are relevant for Vietnam in its current situation.

China's exceptional growth over the past 15 years does, however, demonstrate the value of a pegged exchange rate as a means of protecting international price competitiveness and promoting trade and industrialization, which are key ingredients of Vietnam's economic growth strategy, as they were of China's at a comparable stage of development.

⁴³ Kaplan and Rodrik, op. cit. p. 2.

⁴⁴ Barry Eichengreen, "Capital Account Liberalization and the Fund," Prepared for a High Level Seminar on Capital Account Liberalization and the IMF, 12 December 2005, p. 1.

Because of Vietnam's limited capacity to sterilize reserves in the face of massive inflows of portfolio capital, its pegged exchange rate, and hence its international price competitiveness, are in jeopardy. The "impossible trinity" cannot be avoided. If we take inflation off the table on the premise that nobody wants to see it raise its ugly head once again, then the tri-lemma is reduced to a dilemma. If the authorities choose to protect the price competitiveness of its traded goods sector by maintaining a pegged exchange rate, and if they are unwilling or unable to tighten fiscal policy sufficiently to correct the current imbalances, then by default some form of controls on capital inflows would need to be considered.

In Thailand (2006-07) and Malaysia (1998-99), capital controls do not seem to have had much effect, either good or bad.⁴⁵ In Vietnam, because portfolio flows are so much greater relative to the size of the economy and domestic securities markets, capital controls are likely to have a much greater effect, both positive (in terms of relieving pressure for reserve accumulation and appreciation) and negative (in terms of their impact on financial markets). In the current circumstances, there is no policy that can serve everyone's interests, which is why technical economic analysis alone can only take this issue so far. Ultimately, the hard choices the government faces must be solved by political calculus.

There is a saying: "Nothing focuses the mind like the prospect of a hanging." The same is true of economic crises, which is why, so often, much good comes of them. Most major economic reforms down through time were born out of crises, including Vietnam's transformation (*doi moi*) from a centrally planned to a market economy that began in the midst of an economic crisis in the late 1980s. Even though the current crisis is still a mini one, it provides an occasion for policy makers in Vietnam to focus on a range of potential threats to the sustainability of growth. Macroeconomic instability is certainly one, but it is the one the government routinely monitors and for which it has the levers to manage.⁴⁶ There are, however, other weakness in the foundation on which the economy

⁴⁵ It is worth noting that most developed countries had capital controls for a prolonged period after World War II. For a nuanced assessment of capital controls in developing countries, see Vijay Joshi, "Exchange Rate Regimes: is there a third way?", *World Economics* 4 (4), December 2003, pps. 15-36.

⁴⁶ Recent events illustrate profoundly the need for Vietnamese authorities to improve the availability of timely and accurate data on financial and other economic flows, both for the public and for

grows—in areas such as education and health care, the physical infrastructure, legal and financial institutions, public and private governance, and social equity—that typically do not get the attention that an erupting financial crisis gets, but are more important to the sustainability of growth in the long run.

government regulatory authorities to understand the extent of problems and to evaluate the costs and benefits of policy responses.

Addendum: Issues Requiring Further Research

In preparing this paper, we have encountered several important issues on which there are insufficient data and/or preexisting research. These include (but are not limited to) the following:

1. Data

Is the statistical picture for 2007 and the first months of 2008 presented in the paper accurate? Are official statistics available for the balance of payments, monetary aggregates and other financial statistics for the year 2007?

2. Commodity price shocks

What have been the effects of commodity price shocks on output and employment and what is the appropriate policy response?

3. Measuring “core” inflation

How much of the recent increases in the price level is attributable to exogenous price shocks?

4. Sterilization

Why is Vietnam unable to sterilize foreign reserves purchases as effectively as China?

5. Impact of sterilization on the banking sector

How have sterilization measures, including requiring banks to buy SBV and government debt, raising reserve requirement ratios, interest rate caps and credit controls, impacted bank profitability and their capacity to perform financial intermediation?

6. Currency substitution

What are the implications for macroeconomic management of the large stock of dollar-denominated bank deposits? Has currency substitution contributed to the macroeconomic problems that Vietnam currently faces?

7. Trade effects of exchange rate changes

How vulnerable is Vietnam's export competitiveness to real exchange rate appreciation? China appears to have sufficient market power to be able to pass on cost increases by raising the dollar price of its exports.⁴⁷

8. Portfolio capital inflows and securities markets

What is the role of foreign investors in Vietnam's asset markets? How much of the rise and fall in asset prices is attributable buying and selling by non-residents?

9. Impact of foreign inflows on the cost of capital

What would be the likely impact of controls on portfolio inflows on stock prices, bond yields and the cost of capital in Vietnam? How sensitive is investment to the cost of capital?

10. Dependency

Is Vietnam too dependent on external finance in its various forms—remittances, ODA, FDI, and foreign financial inflows?

⁴⁷ Jonathan Anderson, "So Why Aren't Exporters in Pain?" UBS Investment Research, China Focus, 14 April 2008.

APPENDIX 1: DATA SOURCES

Data for Vietnam were drawn mainly from the International Monetary Fund, *International Financial Statistics*, selected issues, and International Monetary Fund, “Vietnam: Statistical Appendix,” IMF Country Report No. 07/386, December 2007. In piecing together a statistical picture for 2007, we have used estimates provided by Dragon Capital, *Vietnam Focus*, selected issues; HSBC, *Vietnam Monitor*, selected issues; Credit Suisse, *Emerging Markets Economics Research*, March 13, 2008.

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