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Responding to the global financial crisis: Vietnamese exchange rate policy, 2008–2009[☆]

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ABSTRACT

The paper presents an analysis of exchange rate policy in Vietnam during 2008–2009. In early 2008, the country faced a sudden reversal of capital flows as signs of developing domestic vulnerabilities became evident. The downward pressure on the dong then intensified with the onset of the global financial crisis in the fall. In these environments, the Vietnamese authorities responded with various exchange rate policy measures. The paper documents a shift in Vietnam's de facto exchange rate regime, from a basket peg to a simple US dollar peg, when the domestic vulnerabilities became compounded by the evolving global crisis. The authorities utilized additional measures to relieve pressure on the parallel exchange rate. An event study methodology finds little evidence of systematic effectiveness for these policy actions; any effectiveness was short-lived. A close examination of individual actions suggests that the impact of foreign exchange market intervention appeared more consistent than any other type of measure and most effective when combined with other measures.

1. Introduction

The paper presents an analysis of exchange rate policy in Vietnam during 2008–2009, when the country faced a series of domestic and global shocks. Although Vietnam had earlier experienced appreciation pressure amid buoyant capital inflows, in early 2008, the country faced a sudden reversal as signs of developing domestic vulnerabilities became evident. The downward pressure on the exchange rate then intensified with the onset of the global financial crisis in the fall. In these environments, the Vietnamese authorities responded with various exchange rate policy measures to relieve downward pressure on the dong. A novel feature of our analysis is the application of a Kalman filter to the celebrated Frankel–Wei regression, in order to identify the timing of a shift in the de facto exchange rate regime. An event study (or news analysis) methodology is then used to assess the effectiveness of various exchange rate measures in stabilizing the parallel exchange rate relative to the official rate and reducing the parallel market premium.

The paper contributes to the literature on the use of exchange rate policy as a crisis management tool. Although various exchange rate policy measures have been used in the past to respond to a currency crisis, there is a general lack of consensus in the literature on their effectiveness. For example, should a country under a managed float increase or reduce exchange rate flexibility when faced with downward pressure on the currency? Does raising interest rates help arrest a depreciating

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currency when there is a speculative attack? An especially large literature has emerged on the relationship between interest rates and exchange rates (e.g., Caporale, Cipollini, & Demetriades, 2005; Evans & Lyons, 2005; Fatum & Scholnick, 2008; Kim, 2003, 2005). The case of Vietnam is unique in this context as it is a semi-financially open economy. Though it controls capital flows tightly, it condones the existence of a parallel foreign exchange market (see Phylaktis, 1996 for a survey of conceptual issues related to a parallel foreign exchange market). The very use of monetary policy instruments by the Vietnamese authorities to address pressure in the foreign exchange market is an indication of their recognition that they do not have full control over a substantial part of foreign exchange transactions. The experience of Vietnam should therefore yield important implications for other developing countries that are at a similar stage of capital account openness.

There are three major findings. First, the paper verifies that the country's de facto regime switched from a managed float (in the form of a basket peg) to a simple dollar peg. The application of a Kalman filter algorithm to the conventional Frankel–Wei methodology further indicates that the shift took place in June 2008 when the State Bank of Vietnam carried out a number of exchange rate policy actions to stabilize the parallel exchange rate. Second, the paper utilizes an event study (or news analysis) methodology to find little evidence of systematic effectiveness for the exchange rate policy measures in stabilizing the parallel exchange rate and reducing the parallel market premium. Any impact, moreover, was short-lived because statistical significance (the number of successful events) generally declined as the length of an event window was increased. Third, a close examination of individual events suggests that the impact of intervention appeared more consistent than any other type of measure taken alone and most effective when combined with other measures.

The remainder of this paper is organized as follows. Section 2 reviews the major exchange rate policy related actions taken by the Vietnamese authorities during 2008–2009, against the movements of the official and parallel exchange rates of the Vietnamese dong against the US dollar. Section 3 examines how the authorities may have shifted the country's de facto regime in response to the evolving crisis. Section 4 assesses the impact of exchange rate policy actions, including a devaluation of the official exchange rate, a widening of the trading band, an announcement to sell foreign exchange, and an interest rate hike, in stabilizing the parallel market exchange rate relative to the official rate and reducing the parallel market premium. Section 5 presents a summary and a conclusion. Finally, Appendix explains the sources of the data and provides summary statistics on the variables used in the empirical study.

2. Exchange Rate Policy during 2008–2009[1]

2.1. Official and parallel exchange rates in Vietnam

The Vietnamese authorities used various exchange rate policy measures, including interest rate actions, in response to exchange rate developments during 2008–2009 (see Table 1 for a summary). In reviewing the exchange rate developments during this period, however, one must first understand that Vietnam's foreign exchange market consists of official and parallel markets. The official market covers the official rate announced by the State Bank of Vietnam (SBV) and the trading rate determined among commercial banks licensed to do foreign exchange business. Since 25 February 1999, the SBV has followed the practice of announcing on each working day an official US dollar exchange rate of the Vietnamese dong (VND), along with a trading band, on the basis of the average actual exchange rates of preceding days in the inter-bank market. The trading rate at commercial banks is determined freely among the licensed banks, subject to the requirement that buying and selling rates remain within the ceilings and floors established around the official rate (Fig. 1). In contrast, exchange rates in the parallel market are determined by demand and supply conditions, and are for the most part not subject to control by the SBV.[2]

The parallel market is illegal but has emerged in response to the tight control of foreign exchange transactions in the official market. First, according to the 2006 Ordinance on Foreign Exchange, market participants in the official market are limited to commercial banks, credit institutions, and import–export companies. Although import–export companies have access to foreign exchange from commercial banks upon submission of required documents, foreign exchange may not be always available and the required procedures are cumbersome. Second, the authorities impose tight controls on purchases of foreign exchange by individuals, even for current account transactions. The parallel market typically offers more attractive terms for buying foreign exchange, so that individuals and import–export companies that have legally acquired foreign exchange prefer to go to the parallel market, thus ensuring its viability as an alternative source of foreign exchange funding.

2.2. Responding to domestic disturbances, early to late 2008

Though the Vietnamese dong experienced appreciation pressure through 2007 amid buoyant direct and equity investment inflows, the situation changed when it had become apparent that Vietnam faced several economic disturbances.

[1] For information on the legal and institutional details of Vietnam's foreign exchange market, we rely on the official Vietnamese-language material obtained from the State Bank of Vietnam (at www.sbv.gov.vn); for the timing of various policy announcements or actions we have relied on both the SBV website and the information reported in Vietnam's leading Vietnamese-language economic daily ***VnEconomy*** (www.vneconomy.vn).

[2] According to Circular 33/NH-TT, dated 15th March 1989 (superceded by Article 22 of the Ordinance on Foreign Exchange, 2006), foreign exchange transactions can only be carried out through authorized commercial banks and other organizations, and any transactions in the parallel market are illegal. However, the SBV seems to condone its existence and generally refrains from taking legal action against market participants. It is only during periods of significant market volatility that it occasionally cooperates with police to arrest and fine those involved in parallel market transactions.