the inter-bank foreign currencies market. In Jannuary 1998 (before adoption of Decision No 37), due to the imbalance of supply and demand for foreign currenices in the market, banks'buying volume from clients was around USD 280 millions, whcareas the selling volume was about USD 340 millions. After 3 months of enforcing Decision No 37, the interbank trading activities were significantly improved to meet the demand for currencies of enterprises and cease the tense of foreign currencies. The buying volume exceeded the selling volume. In February 1998, banks' trading volume with clients was up by 85% compared with the previous month. Especially, the trading volume in March 1998 increased by about 34% in comparision with that of the previuos month. More specificly, monthly average banks' trading volume with clients in March and April 1998 was approximately a billion USD.(The trading volume in April was up 7% compared with that in March).

Trading volume between banks in the inter-bank foreign currencies market was also up in comparison with the previous periods. Trading volume in February 1998 was about 80% higher than the figure of January; trading volume in March was nearly 16% higher than in February; and particularly, total trading value between the banks in March had reached high level of around USD150 millions, which was up by more than 70% comparing with the preceding month. During implementation of the Decree No. 37, foreign currencies buying value is always larger than selling one. In assessing operation of the interbank foreign currencies market, it is possible to conclude that the exchange rate that is determined in the interbank market has attracted market participants, creating initial conditions for market to function normally.

In brief, the Prim Minister's Decision No.37/1998/QD-TTg dated 14th February 1998 *was issued timely, giving solution to remove standstills in foreign currencies supply and demand, concentrating foreign currencies into banking system, preventing illegal speculative activities and misuse of foreign currencies, contributing to satisfying foreign currencies needs of importers, improving transactions in foreign currencies market and stabilizing exchange rate*. Thanks to Decision No.37 and other strict regulations on foreign exchange management, the State Bank was able to make little market intervention in 1998 in spite of adverse impacts from regional economic crisis. *This practice had partly helped to ensure the rising trend of national official reserves in 1998.*

2.2 Surrender requirement

In fact, the surrender requirement was first introduced when the Government issued Decision No.137/1998/QD-TTg dated 12 September 1998 regarding obligation to sell and right to buy foreign currencies of institutional residents.Given Vietnamese economy with heavy dollarization, surrender requirement is considered an essential and appropriate administrative measure. Decision No. 37 was followed by Decision No.173, which had brought in such positive effects as:

- *To put an end on speculative hoarding of foreign currencies. Foreign currencies are concentrated into banking system for the purpose of effective using.* This can be observed through foreign currencies buying activities by banks. From 12th September 1998 to 28th May 1999, the value of bought in foreign currencies by commercial bank from current receipts was approximately USD 2 billions (an monthly average of USD 230 millions), counting for a significant part in the total bought in currencies, included and from the balances of deposit accounts since 12th September 1998 (about USD 2,100 millions)

- *To solve difficulties in foreign currencies supply, to ease pressure on exchange rate, to improve operation of interbank foreign currencies market and to satisfy basic requirements of enterprises.* As mentioned above, after issuing of Decision No.37, by April 1998, banks' foreign currencies buying turnover from clients was higher than selling turnover. However, in the following months of 1998, foreign currencies buying turnover of banks was down and lesser than selling turnover due to limitations of Decision No.37 and bad effects of monetary crisis that had pressures on foreign currencies supply-demand in the market and on value of Vietnamese Dong. Especially in months from June to August, average foreign currencies trading turnover of banks was down from USD 1 billion level in March and April to nearly USD 500 - USD 600 millions per month. After implementation of Decision No.173, the situation was improved. In the last three months of the year, average trading volume had reached nearly USD 900 millions per month, comparing with average level of USD500 millions per month in the first nine months of the year. Only in December 1998, total trading volume was more than USD1 billions, in which buying turnover was USD516 millions and selling turnover was USD505 millions. Basically, banks had satisfied foreign currencies needs of enterprises.

  With the decisive and thorough guidance from the State Bank, the surrender regulation was implemented uniformly in commercial banks and made contributions to promoting operation of foreign currencies interbank market.

- *To contribute to exchange rate stabilization and exchange rate management. This surrender regulation helped to cease tensed situation of foreign currency supply-demand in market and pressure on exchange rate. Together with exchange rate adjustment in August 1998, the market rate gradually become stable, the differences between official and free market rates were narrowed.* (Development in exchange rate will be discussed in more details in later parts)

However, there are still disadvantages in the regulation on foreign currency surrender:

- Surrender requirement is not economic, but rather an administrative and obligatory measure. Due to this, it can not be applied in the long run, especially given circumstance that we need to establish preconditions to make Vietnamese Dong a convertible currency.
- This regulation does not set an equal playing ground for all enterprises. Foreign invested companies which are not guaranteed by the Government to assist in foreign currencies balancing do not have to obey their obligation to sell currencies and have the right to buy currencies for current as well as

eligible transactions. Besides that, enterprises always take loss due to difference between buying and selling rates.

- The regulation makes enterprises and foreign investors feel fear that they possibly can not buy back needed foreign currencies amount after selling to banks.
- Enterprises do not have enough autonomy and authority in managing their foreign currency capital. They face many difficulties in doing other businesses.
- It is difficult either to distinguish between foreign currency sources that are obligatory to sell (the current ones) and other sources.

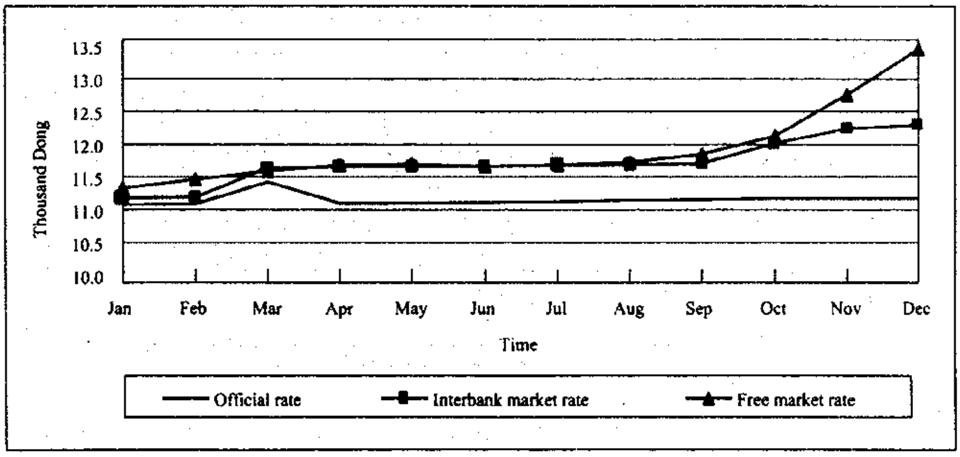
2.3 Effects of exchange rate management measures on foreign currencies market

- At first, the effects of exchange rate management on foreign currencies market from 1994 up to now can be found in exchange rate developments during these years. It is important to notice that *the official announced rate is closer to the reality and suitable with supply-demand relationship, thus enhances managing ability of the State determined rate and narrows the gap between foreign currencies interbank market and free market. The exchange rate is stable in both official and free markets.*

As mentioned in part 1.4 above, there were some limitations in the exchange rate management from 1994 to 1996. This official announced rate was not adjusted flexibly, although it was based on supply-demand situation in the market.

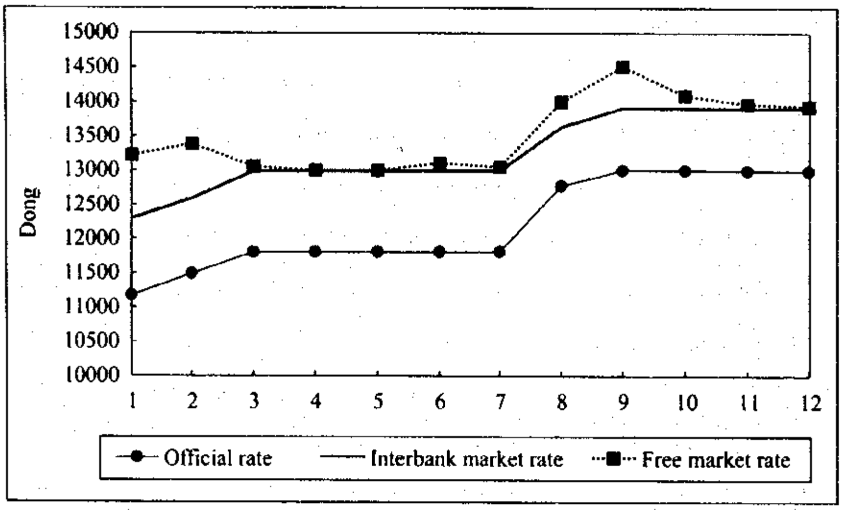
+ In 1997, the State Bank widened exchange rate band to +/-5%, then to +/-10%, and gradually increased the official rate from 11,055 VND/USD at the beginning of the year to 11,175 VND/ USD at the end of the year. These actions of the State Bank had contributed to flexible adjustment of exchange rate in the market and reflected the true purchasing power of Vietnamese Dong. (Chart 1: Exchange rate VND/USD in 1997)

Chart 1 Exchange rate VND/USD in 1997



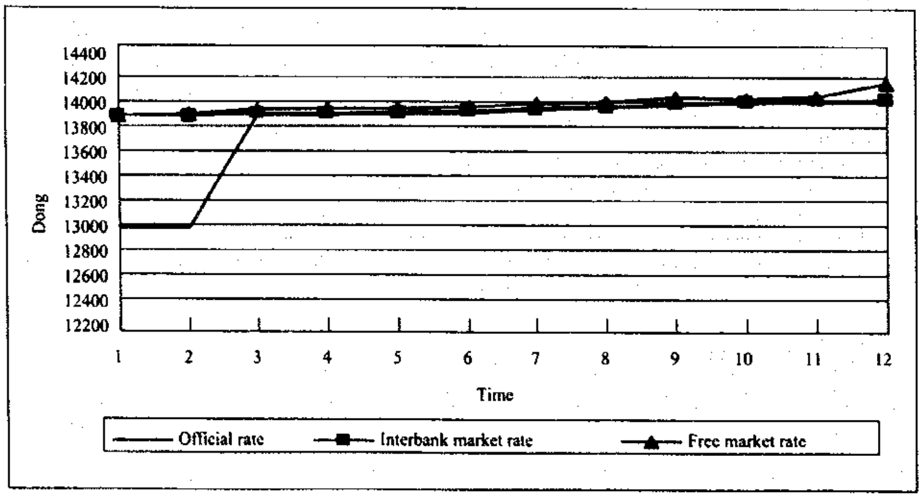
+ In 1998, after two adjustments of official rate, the band (the difference) between official and bank's rates, the exchange rate in interbank market always reached the highest permitted level. The official rate was up by 16%; the interbank rate was up by 13%, from average level of 12,293VND/USD in January to 13,895VND/USD in December. During the first two months of the year, there was big difference between rates in interbank and free markets. But the difference was narrowed in the following months and became insignificant in the last two months. The exchange rate shocks were overcome. At the end of 1998, the free market rate were around 13,000 VND/USD in comparision with that rate (for cash) on 13 August and in September 1998 of around 15,000VND/USD. (Chart 2: Exchange rate VND/USD in 1998)

Chart 2 Exchange rate VND/USD in 1998



+ Generally in 1999, the VND/USD exchange rate was rather stable. Comparing with the year of 1998, the interbank exchange rate increased by 1%, the free market rate increased by 1.1% (Chart 3: Exchange rate VND/USD in 1999).

Chart 3 Exchange rate VND/USD in 1999



- Exchange rate adjustments in the past years together with other measures such as Decision No. 37, Decision No. 173 on foreign currencies surrender, stipulations on Vietnamese overseas remittances *have partly helped to stop the standstill situation in foreign currencies interbank market. The trading volume in the interbank market has a tendency to increase. The supply of foreign currencies is also encouraged to meet the demand of economy.* Analyzing operation of interbank market in the face of the above mentioned foreign exchange management policies can prove this. An example could be the case in October 1997 in which trading volume of the interbank foreign currencies market was surprisingly increased after widening of trading band. In some special days, the volume even reached high level of USD25 millions per day.
- Exchange rate adjustment has produced *lesser pressures on state reserves. The State Bank is able not only to restrain selling foreign currencies to keep exchange rate stable, but also to build up official foreign reserves.* Moreover, through the interbank market, the State Bank can observe foreign currencies supply-demand situation in order to take appropriate actions where necessary. In addition to that, exchange rate management in the past years *has positive effects on increasing foreign reserves for the country* (by export promoting, import controlling that lead to increase in foreign currency supply). The official foreign reserves of Viet Nam have been increasing and equal to 13 import weeks at present (Note that in 1996 and 1997, foreign reserves were equal to about 9 and 10 import weeks, respectively).

3. Effects of exchange rate and foreign exchange management on imports and exports

As it is discussed in part 2, new regulations on foreign exchange management and flexible exchange rate management regime are conditions for export promoting, import controlling, improving current account and increasing official foreign reserves. The remarkable impacts of these measures are reflected in great efforts to cease foreign currencies imbalance in market, to meet foreign currencies needs of enterprises and reduce pressures on exchange rate. Through these results, foreign exchange management policies have indirect impacts on import and export activities of the country.

There are policies that have direct impacts on import, too. These policies can be the ones regarding management of short-term borrowing by enterprises, particularly regulations on deferred L/C. In fact, although Decree No. 58/CP was issued by the Government in 1993, but management over external debts owed by enterprises was not properly and strictly carried out, especially management over opening of deferred L/C. The consequence was that by 1996, excess import (current account deficit) was at alarming level, of which importing by deferred L/C counted for a significant part (In 1995, imports by deferred L/C counted for 18% total import value). These deferred L/C matured at the end of 1996 and in the beginning of 1997, which make foreign currencies demand sharply go up and have pressure to drive exchange rate up. To solve these problems, the Government have applied several regulations governing deferred L/C opening, namely: Regulation on deferred L/C opening promulgated under the Decision No. 207/QD-NH7 dated 1st July 1997, Decision No. 802/TTg dated 24 September 1997 of the Prime Minister on dealing with remained consequences of deferred L/C. These regulation have forced banks to be cautious in making guarantee for this payment method. L/C turnover has gone down after implementing measures to restrict deferred L/C opening, included requirement of minimum deposit of 80% L/C value. The government also set limits on deferred L/C opening to import non-essential consumer goods as decided by the State, temporarily stopped to import some goods and adjusted exchange rate. These actions have achieved good results. In 1998, deferred L/C balance at commercial banks had down by nearly 50% comparing with the previous periods. In 1998 too, current account of Viet Nam was improved. Current account deficit stood at 3.8% GDP, compared with 6.5% GDP of 1997. Those results were even more meaningful in circumstance where financial - monetary crisis occurred in the region.

It is clear that exchange rate is a very sensitive element. It reflects purchasing powers of different currencies through international trade relationship. There are many opinions that exchange rate adjustment towards raising value of foreign currency would ensure the objective of export promotion. However, export capacity of a country depends on many other factors as well: competitiveness of the economy and of exporting products in international markets, type and quality of goods and services, technology, marketing,etc. With respect to export capacity of a country, exchange rate is an important, but not a decisive factor. This conclusion could be proved by the increasing export turnover of Japan and German during the years in which currencies of this countries were continuously appreciated in comparison with the US dollars. Thailand could be another case. During the regional crisis, Thai exporting turnover did not go down in spite of devaluation of Thai Bath in comparison with the US dollars. Some researches have founded that domestic currency devaluation would have J-curve type effect on export activities. That is why domestic currency devaluation does not necessarily improve trade balance. In addition, it is worth to notice that there are 3 main groups in the structure of exporting goods of Viet Nam: heavy industrials and minerals, light industrials and agricultural. Representatives for these three groups are crude oil, garments, footwear, and rice, which are Vietnam's leading exporting products (Table 1). However, it is important to know that nearly all Vietnam's exporting products are raw materials with low price elasticity. As far as rice concerns, rice exporting volume has strong increase through years, bur the exporting value is not high due to low quality and low price. Garments and footwear have gained high exporting value, but they require imported materials. Revenue from exporting these products counts only for 20% total export revenue. So, based on this situation, it is possible to note that exchange rate adjustments towards increasing value of the US dollar in comparison with Vietnamese Dong affected export promoting and import controlling to some extent. Though, these effects on net export, or in other word on trade balance, were not so noticeable.

3.1 Effects on exports

Exchange rate adjustments made in the past year, particularly during regional financial - monetary crisis had positive effects on export through contributing to decrease difficulties for exporters, improving competitiveness of exporting products in international markets. In addition to that, exchange rate adjustments also helped exporters to gain higher profits (as in case of rice exporting) or to reduce losses (in case of rubber, crude oil or coal). According to the Government's Price Committee, after exchange rate adjustment in August 1998, rice exporters gained profits at about 90,000 - 100,000 Dong/tone. The return on price adjusted to the foreign exchange rate was up by 5%-10% in comparision with that of unadjusted price. With regard to rubber, exports of this item heavily depends on the prices in international markets. However, after exchange rate adjustment, a loss of about 844VND/USD was replaced by a profit of 50VND/USD. As for crude oil and coal, the exchange rate adjustments in 1998 helped the exporting enterprises mitigate the losses (the decrease in international prices caused the reduction of their revenues in foreign currencies.)

An important impact of timely and flexible exchange rate adjustments can be found in exporting activities of Viet Nam since 1997. From July 1997, countries in the region had devaluated their currencies (Thai Bath: 46%, Philippians Peso: 40%, Malaysian Ringit: 38%, Singaporean Dollar: 18%, Korean Won: 53% and Japanese Yen: 14%). Meanwhile, Viet Nam mainly exports the similar products as of these countries. Because of that, competitiveness of our exporting product was weakened to certain extent in international markets. However, Viet Nam had successfully maintained its total export turnover at level of USD 9,269 millions (at FOB), which was up by 26% comparing with 1996.

Coming to year of 1998, given overvaluation of Vietnamese Dong, the diminishing competitiveness of Vietnam's exporting products was constrained thanks to devaluation of Vietnamese Dong by 16%. So, instead of being decreased due to regional economic crisis, export turnover was still at level of USD 9,300 millions, which was a little higher than turnover of USD 9,269 millions in 1997. Next, in 1999, thanks to measures to develop foreign currencies market and new exchange rate management regime, the exchange rate of Vietnamese Dong, established on the basis of transactions in the market, had objectively reflected purchasing power of Vietnamese Dong and created condition for exchange rate stabilization. Following the whole decade of continuos deficit, trade balance had experienced high surplus of USD 1,080 for the first time. Export turnover reached USD11,540 millions (at FOB), which was up by 23% in comparison with 1998.

So, during the past years, despite the regional monetary crisis, export turnover of Viet Nam still continued its development trend. Exchange rate adjustments made in period 1997 - 1998 have somewhat produced negative impacts on input expenditures of enterprises, leading to higher producing cost of some export goods. However, these impacts were not so significant. Exportation of such leading products as rice, crude oil, garment, footwear is increasing year after year.

3.2 Effects on imports

Exchange rate adjustments help to take control over import: a higher exchange rate forces importers to consider carefully about importing non-essential goods. Declining import is a reason to encourage using of available import-substitute materials and domestically produced goods. An example could be drawn from petrol trading companies that have to pay for imported petrol in foreign currencies, but can only sell it for Vietnamese Dong in domestic market at a predetermined price level. As far as this type of product concerns, the more companies import and sell in domestic market, the more they suffer from losses. In 1997, import growth was restrained to nearly 1% more than in 1996. In 1998, import was also tightly controlled by an adjustment of the official exchange rate from 11,175 VND/USD to 12,998 VND/USD together with some other measures on import restrictions. Total import turnover in 1998 stood at USD10,080 millions (at FOB), which was down by 4% comparing with 1997. Total import value in 1999 reached level of USD10,460 millions, which was 3.7% higher than in 1998, but still much lower than export growth rate. Particularly, in comparison with 1998 figures, importing of some goods was sharply decreased: black cement (down by 273%), wheat flour (by 116%), seasoning (by 108%) ...

4. Possibility of introducing the convertibility of Vietnamese Dong.

Vietnamese Dong convertibility is one of the issues related with macroeconomic management of the market economy. Especially it is closely related with international trade relationships, the international capital flows, flows of FDI. Implementing convertibility of Vietnamese Dong also strongly affects the process of economic development and integration of Viet Nam economy into global economy. The process of making one currency be convertible usually has 2 stages: implementing current account convertibility and next stage is implementing capital account convertibility.

- Current account convertibility: Convertibility of a currency is applied toward current account transactions, i.e. it is allowed to convert the local currency into foreign currency to make payment for exports, imports of goods and services with other countries. Establishing current account convertibility also means that there is no restriction over the current account transactions, the exchanges of goods and services with foreign countries.
- Capital account convertibility: A country applies capital account convertibility, i.e. the country allows the conversion of local currency into foreign currencies to attract foreign funds. In fact, capital account convertibility is implemented basically with the aim of attracting foreign investors by accommodating their profit repatriation. However, implementing capital account convertibility might put the country under the exposure of the foreign exchange rate fluctuations, the capital flight, as the drain of international reserves v.v. Therefore, the countries usually implement the capital account convertibility on the foundation of real economic development and success of current account

convertibility.

4.1 Possibility of implementing Vietnamese Dong convertibility

Implementing a currency's convertibility is a complicated issue. In order to avoid risks and mitigate its adverse effects on the activities of the whole economy, it is necessary to prepare all the preconditions for implementing convertibility of a currency thoroughly. As experienced by some countries, they usually implement the convertibility of their currencies as long as the economies have already developed and been stable and the necessary conditions have been created such as: Foreign exchange rate management on the market principles, the dynamic foreign exchange management mechanism with abolishment of the foreign exchange restrictions, the reasonably adequate level of international reserves, sound and healthy financial-banking system, interest rate liberalization and management of monetary policy by using indirect instruments, implementing open door policy and trade liberalization, having the measures that force the manufacturing and trading units to be timely adaptive with the market prices.

In the process of globalization of the economies, the introducing of currency convertibility is inevitable. But the issue of concern is the scope, timing and the types of convertibility. With regard to Viet Nam, some opinions say that although Viet Nam has some favorable conditions Viet Nam still has not have sufficient conditions for implementation of Vietnamese Dong convertibility. Thus, the decisions of implementing Vietnamese Dong convertibility should be made thoroughly. In fact, Viet Nam has created some conditions, but still has to improve the remaining conditions, as follows:

a. Foreign exchange rate arrangement

The first condition for implementing currency convertibility is having appropriate foreign exchange rate regime and managing exchange rate according to the market principles. That means the foreign exchange rate should be determined on the supply-demand relationship in the market and truly reflect the internal and external purchasing power of a currency. At present, the foreign exchange rate in Viet Nam is just determined on the relationship of supply of and demand for foreign currencies in the foreign currency interbank market. With Decision No 64 and Decision No 65 of the State Bank of Vietnam's Governor dated 25 February 1999, since February 26, 1999, the State Bank of Viet Nam started to announce the official rate of the previous working day. It is a fundamental move of foreign exchange rate management mechanism. However, the foreign currency interbank market in Viet Nam has not developed yet. Therefore, the foreign currencies interbank rate has not reflected truly the purchasing power of Vietnamese Dong. The gap between interbank rate and free market rate has been narrowed but still exited. At present, the policy of flexible adjustment of the rate and of the band is in line with the movements of balance of payments is an appropriate one. Nevertheless, to make Vietnamese Dong be convertible, Viet Nam should continue to develop foreign exchange market so that the market rate is fully determined by market forces.

b. Foreign exchange Management

As mentioned earlier, over recent years, the process of renovating control over foreign exchange and foreign exchange related activities has been implemented. With issuance of Degree No 63/1998/ND-CP, Viet Nam has formulated a relatively comprehensive and systematic legal framework aimed at gradual implementing Vietnamese Dong convertibility. Based on the stipulations of the Degree and other related regulations, the foreign exchange restrictions have been gradually relaxed. This can be obtained through the process of implementing foreign exchange surrender requirement. So far, according to Decision No 180/QD-TTg of the Prime Minister dated 30 August, 1999 the surrender ratio were down to 50%. The Decision was a step forward liberalization of foreign exchange transactions. As estimated, in the year of 2001, the surrender requirement will be totally removed. The remaining foreign exchange restrictions such as foreign exchange self-balancing requirement, tax on repatriation or remittances of profit applied toward foreign-invested enterprises have been significantly relaxed step by step. Especially, the foreign exchange balancing requirement has just been fully abolished in 2000. Besides, other previously applied restrictions over private transfers were also cancelled out by allowing the receipts of the remittances in different forms including in cash foreign currencies. As estimated in 2 - 3 years, the remaining restrictions over the current payments and transfers will be eliminated. Thus, so far Viet Nam has already prepared some conditions for current account convertibility.

c. International reserves

It is a significantly important condition for coping with the BOP imbalance or the fluctuations in terms of trade. Without a reasonably adequate level of international reserves, the country will be exposure to the risks, interest rate and foreign exchange rate will be unstable. On the other hand, having an appropriate level of international reserves in also a condition for ensuring public confidence in the macroeconomic policies. With this regard, Viet Nam still has some disadvantages. After a number of years having BOP deficit, in 1999, Viet Nam had a surplus of BOP of USD 1,600 millions, contributing to the increase of international reserves. However, at present, the level of international reserves is still limited, just accounted to about 13 weeks of imports. In the years to come, with the improvements in competitiveness of Vietnamese exported goods, in BOP, external debt management and the regained confidence of the foreign investors in Viet Nam investment environment, Viet Nam is expected to have a reasonably adequate level of international reserves to implement Vietnamese Dong convertibility. In the short-run, Viet Nam needs to create a structure of major exported goods, which can be competitive and attractive in the regional and international market to increase international reserves to assist implementing Vietnamese Dong convertibility.

d. The financial - monetary system and money market

Presently, Viet Nam is on the way of strengthening the financial - monetary system by restructuring the state-owned commercial banks and the joint-stock private banks. The process is implemented with the objective of making the banking sector sound and transparent. And it is conducted simultaneously with the SOE reform. In the following years, in the process of international integration with implementation of the commitments with the international organizations and groups (AFTA, APEC, ...) and especially of USA - Viet Nam trade agreement, the banking sector of Viet Nam will be developed and its competitiveness will be enhanced. The expansion of the operation scope of foreign banks will contribute to the development of the banking sector. Besides, the developments of money market and stock market also will be the necessary conditions for Viet Nam to implement Vietnamese Dong convertibility toward current account and next toward capital account.

e. Monetary policy and interest rate management

Among the macroeconomic policies, monetary policy plays an important role with the objectives of ensuring the currency stability, controlling inflation, thus creating a relatively stable macroeconomic environment, accommodating economic growth. Establishing Vietnamese Dong convertibility for capital flows and implementing trade liberalization without stable macroeconomic environment will cause the over-excessive imports of goods which leads to the international reserves drain, causing pressure on foreign exchange as well as domestic interest rates. At present, monetary policy is gradually renovated in line with the market economy and the process of international integration. The shift from using direct instrument to indirect instruments with the birth of open market operation (OMOs) marked a significantly important step toward the aim of creating stable macroeconomic environment with the above-mentioned objectives. Besides, the adoption of base interest rate instead of ceiling of interest rate is also a step toward interest rate liberalization. In near future, the State Bank of Viet Nam will continue to manage base interest rate flexibly. It can be considered as the preparation for interest rate liberalization, which is one of the necessary conditions for implementing Vietnamese Dong convertibility.

g. Open policy and trade liberalization

As mentioned earlier, regarding this condition Viet Nam has some advantages, So far, Viet Nam has made efforts in implementing open door policy of the economy by enhancing the trade transactions with other countries in the region and in the world, attracting foreign capital and entering international organizations, regional groups or international groups. Regarding trade liberalization, Viet Nam has committed with AFTA, APEC and next WTO to enter these organizations. However, to ensure the competitiveness of the country, stability and development of the economy, Viet Nam has to have appropriate policies supporting and protecting domestic production, enhancing the quality of exported goods. It is an important condition for implementing the Vietnamese Dong convertibility successfully.

h. The measures forcing the manufacturing and trading units to be adaptive with the market mechanism.

When Vietnamese Dong is convertible, the domestic manufacturing and trading units will face with the competitiveness in the international market. Over recent years, with the gradual implementation of open door policy of the economy toward the objective of trade liberalization, the domestic producers have had to be familiar with the competitiveness of imported goods of the same categories of other countries. Implementation of Vietnamese Dong convertibility will speed up this process. Whereas under influence of centrally-planned subsidized mechanism, the domestic producers are still not familiar with the market signals. So in the process of economic renovation, it is necessary to cease subsidy the losses from the state budget and encourage the producers to be adaptive quickly with the prices in local markets as well as in the international market. This will help the domestic producers be ready to cope with the challenges of introducing Vietnamese Dong convertibility. It is a micro issue but very necessary for implementing Vietnamese Dong convertibility.

4.2 The steps of establishing Vietnamese Dong convertibility

After creating necessary conditions, Vietnamese Dong convertibility can be realized as follows:

- First, implement current account convertibility. This process should be implemented step by step and thoroughly. And it is to be realized on the foundation of establishment of all necessary conditions and the management capacity, as well as in line with the trade liberalization schedule.
- Capital account convertibility should be realized lastly as long as the finance - monetary system is healthy and an imbalance of BOP is not exited, the international reserves have stably increasing tendency. Implementation of Vietnamese convertibility on the foundation of the establishment of preconditions, with firm steps will significantly affect the activities of the economy. Otherwise, it will cause risks and crisis, as in the cases of East-Asian countries. The lessons from East Asian crisis show that one of the reasons of the crisis is too early relaxation of foreign exchange management by the central banks, too early implementation of capital account liberalization without healthy finance - monetary systems, and closely related macroeconomic management measures, unified legal framework.

5. Exchange rate control

5.1 Exchange rate and exchange rate regime

It is necessary to repeat that exchange rate is the price of one currency expressed in other currency. Nominal exchange rate is just a relative price of one currency expressed in other currency. So, fluctuations in nominal exchange rate are all kinds of changes in exchange rate that we observe every day and that are not adjusted to inflation. Meanwhile, the real exchange rate reflects comparison of relative prices of goods in two countries, which means that inflation factor is counted. Besides that, it is important to note that exchange rate regime followed by a country could be fixed, clean floating or "dirty" (managed) floating. According to detailed classification by the IMF, certain countries apply fixed exchange rate regime by pegging their local currency to another currency (usually a strong one like the US dollar) or to a basket of currencies. In this case, value of the domestic currency is adjusted less often or with a prefixed level to its pegging currency. Other countries prefer managed floating exchange rate regime, in which the local currency fluctuates around the US dollar within a narrow band and is adjusted regularly according to supply, demand, inflation, balance of payment, foreign reserves. Some developed countries allow their currencies to be float and determined by market forces, and make intervention only in case of necessity. Each exchange rate regime has advantages and disadvantages. In addition, exchange rate is affected by series of different factors. The economic factors that have direct impact on exchange rate include stability in economic growth rate, trend in international balance of payment, development of inflation. These factors determine internal and external purchasing power of the currency. The indirect factors are political, social, and psychological. For that reason, choosing an appropriate exchange rate regime usually based on such elements as inflation rate, foreign reserves, export and production diversity, policies' flexibility and sustainability, political and commercial integration, price and salary flexibility.

5.2 Exchange rate control and management in Viet Nam

In Viet Nam, from 1994 to the end of 1996, Vietnamese Dong fluctuated around 11,000VND/USD. This proved that exchange rate regime of Viet Nam in that period had main objective of ensuring stability of exchange rate. In other words, Viet Nam followed then a fixed exchange rate regime, aiming at inflation controlling and enhancing credibility of Vietnamese Dong. In fact, Viet Nam managed mainly nominal exchange rate between Vietnamese Dong and its pegging US dollar. However, different studies have found that although Viet Nam has success in managing stable nominal exchange rate, but it makes Vietnamese Dong gradually overvalued. Furthermore, as showed by experiences of some Asian countries, pegging of local currency to another currency (US dollar) for a very long period usually leads to overvaluation of the former one and it is one of reasons of Asian financial - monetary crisis.

In recognizing this situation, to get over adverse effects of regional monetary crisis, since 1997, Vietnamese Government moves step by step from the stability-focused exchange rate regime to flexible management regime. In reality, counting from 1997, exchange rate management in Viet Nam is carried out with increasing flexibility but ensuring ultimate goal of currency stability. The trading band is widened several times, accompanying with changes in official rates in the years of 1997 and 1998. So, it is possible to say that exchange rate regime applied by Viet Nam during 1997 and 1998 was the managed floating regime. More precisely, local currency was pegged to the US dollar with frequent adjustments.

In 1997 and 1998, the State Bank made adjustments to exchange rate in considering necessary conditions, as follows :

- Evaluate developments of inflation in order to find out real appreciation of Vietnamese Dong relatively to neighbors' currencies.
- International trade situation at the end of 1996 and diminishing competitiveness of Vietnamese

exporting goods due to regional crisis required that the US dollar should be raised in value against Vietnamese Dong. Besides, many of Vietnamese exporting products are similar to the ones of neighbor's competitors. This is one of factors that affect exporting results (through comparative competitiveness of Vietnamese and these countries' products in international market).

- The official foreign reserves are still limited, although they have been built up a lot in past years. The fixed exchange rate regime is not implemented in Viet Nam. Anyway, in order to ensure stability of its currency, Vietnamese government should consider suitable adjustments to exchange rate so that it can avoid market chaos that requires intervention from the State Bank and badly affects national official reserves.
- Interbank foreign currencies market is underdeveloped. That is why fluctuation band should be determined carefully to encourage market operations.
- The practice of implementing monetary policy and interest rate management measures would serve to set integrated set of solutions concerning interest rate and exchange rate (to restrain transforming flows from Vietnamese dong to US dollar and vice versa in case of exchange rate and interest rate fluctuations).
- Estimate foreign currencies inflows and outflows. Thanks to controlling procedures over flows of funds and low capital mobility, the impacts of flows on exchange rate remain insignificant. Anyway, as mentioned in part 1, changes in domestic exchange rate and interest rate could affect capital outflows in the form of foreign currency deposits abroad.
- Other psychological conditions: in case of devaluation, people always fear of further devaluation. This expectation has distorted real demand of foreign currencies and puts pressure on exchange rate.

Especially since February 1999, the State Bank began to consider the average trading exchange rate in interbank foreign currencies market as the officially announced rate. Exchange rate of commercial banks was established on the basis of this official one with a maximum fluctuation band of 0.1%. It is possible to say that since then, the exchange rate was managed according to market principles. The prevailing exchange rate control regime differs in certain ways to the previous ones. However, because the interbank foreign currencies market in Viet Nam is still underdeveloped in both trading volume and number of participants, the exchange rate of this market can not absolutely reflect the true purchasing power of Vietnamese dong. In addition, the concerning issue at present is how to set an appropriate trading band in considering such key factors as inflation, changes in domestic and external interest rate, international trade situation in general and balance of payment in particular.

At this time, Viet Nam does not have enough conditions to implement pure floating exchange rate regime. This means that the government's intervention in market can not totally removed. In case of necessity, the State Bank needs to use official reserves to intervene market. Because of that, it is required to build up foreign reserves in order to control exchange rate. Moreover, openness of the economy has tendency to be increasingly widened, leading to the fact that external economic shocks could affect Vietnamese economy, too. Other considerations such as development of financial - monetary system, interest rate management towards liberalization are vital to choose suitable exchange rate.

B − 3

The Relationships Exist among Credit Markets, Foreign Exchange Markets and Securities Markets

Le Phuong Lan

State Bank of Viet Nam

The financial system in Viet Nam was dominated by the activities of the banking system for many years under the centrally planning economy. Viet Nam economic reform which started in 1980s from plan to market orientation requires financial system to be designed to meet the needs of market economy. Until now, the market- oriented financial system has been developing and consolidating, beside which the relationship among financial markets also has been formed and changed. This paper will present the relationships exist among credits markets, securities markets and foreign exchange markets after outline some main features of those market in Viet Nam.

Credit market and interest rate control

Banking credits market was the sole channel to transfer funds from surplus to deficit sectors in the former economy.To date, banking credit has been regarded as a basic financing source to meet the needs of funds. Operational characteristics of credit market in Viet Nam thus was affected heavily by credit control and interest rate control of the State Bank of Viet Nam (SBV).

The SBV maintained the nominal interest rate at the fixed rate in a lengthy period, and this rate was much lower than inflation rate at the same time, therefore the real interest rate commonly was negative. State owned enterprises had to open accounts with banks and deposited all their money to those accounts according to restrict and administrative regulations and rules. In private sectors, under the high inflation rate and unstable domestic currency, economic agents and individuals preferred valuable assets, gold and foreign currencies to bank deposits and hence attempted to protect the real value of their assets. The credit market depended mainly on the fiscal finance.

Beside the progress of economic reform, banking system also has been reformed since 1990, started by splitting the mono-bank into two-tier banking system with two separate functions: state monetary management and banking business. The interest rate policy also has changed, beginning from an increase in nominal interest rate in 1989. With the great effort to curb inflation, real interest rate was maintained at the positive level. This change creased the incentives in economic agents and individuals to deposit their money into bank accounts. Mobilised fund increased dramatically, with which banking ability to provide credit to the economy also increased. The next steps of interest rate adjustments took place since the mid-

1992 to the end-1993 with the downward trend that was in line with the decreasing growth rate of inflation. The discrimination of interest rate between various sectors and industries basically was eliminated.

From 1993, 1994 and 1995, SBV only imposed ceiling on lending interest rates and fixed deposit rates, in stead of setting fixed rate for various types of loans as well as deposits as SBV had done previously. Under this ceiling, commercial banks could adjust interest rates on loans at their desirable level. In addition, there was the existence of a new type of interest rate called "agreement interest rate" for long and medium term projects, which actually was adjusted by the relationships between supply of and demand in the credits market.

From 1996, interest rate control continued changing and SBV only maintained ceiling on lending rates and liberalised deposit rates. Under the ceiling level, commercial banks could decide the interest rates for each type of loans. From the middle -2000, "basic interest rate controlling mechanism" will be introduced.

Those steps in adjustment of interest rate control aimed to interest rate liberalisation gradually and carefully, matching with the different stages of the development of domestic financial system. The deposit rates at times even exceed the loan rates. This approach seems to be a paradox in banking business, but this is likely to be suitable to the background of Viet Nam economy, sin this not only contributes to bolster the demand for domestic currency deposits under the circumstance of exchange rate uncertainty, weakness of official foreign reserve, currency substitution and the low confidence in the banking system, but also limits the negative effects of the increase in real interest rate on the demand for investment. However, this approach also led to the accumulation of excess liquidity in many commercial banks, making inefficiency in banking operations and credit allocation.

Foreign exchange market and capital control

The main features of the financial market in Viet Nam are the high degree of dollarization and the existence of the parallel market for the illegal exchange transactions. The use of USD was common in the South of Viet Nam under the war. Post war, USD was a creditable instrument to serve as store of value, unit of account and medium of exchange under the circumstance of high accumulation rate of inflation and the weakness in economic performance. Despite holding and using USD in transactions were not allowed by regulation of foreign exchange control, a large amounts of foreign exchange was still held by individuals and enterprises, floating and using in payment transactions in parallel market outside the government controlling.

Thus, the exchange rate policy in Viet Nam was too difficult to be used to intervene in the foreign exchange market. Until March 1989, Viet Nam government still maintained a multiple exchange rate for different trade transactions. Though exchange rate was adjusted frequently, the official rate was still much far from the rate in parallel market. Actually, domestic currency tended to be overvalued by SBV, causing a great loss for exporters and benefit for importers.

SBV undertook the first step in devaluation of domestic currency in 1988. A new exchange control Decree issued on October 21, 1988 was designed to attract the foreign exchange that had been traded in parallel market into the banking system as well as to adapt the exchange system to the new laws liberalising foreign trade and investment. In March 1989, by unifying all different exchange rates and publishing the official rate closing the exchange rate in parallel market, the SBV officially devalued the domestic currency five times. Other reforms in strict administrative control approaching to liberalisation were also taken place. With the progress of reform, a large amounts of foreign exchange in parallel market was driven into the banking system, substantially increased the supply of foreign exchange in official market.

In the effort to introduce a market for official foreign exchange transactions, the SBV set up a foreign exchange trading floor in Hochiminh city at August 1991 and in Hanoi at November 1991 in which the SBV introduced the maximum margin on either side of the official reference rate. However, those two floors seem to operate ineffectively. On 14 October 1994, the SBV set up the inter-bank market for foreign exchange by the Decision number 204/QD-NH1 of the Governor, replaced two former trading floors. SBV introduced the band of 0.5% on either side of official reference exchange rate in which the selling and buying rates were allowed to move. The official exchange rate was adjusted daily according to the relationship between foreign exchange demand and supply in the market. Most of the big commercial banks have joined the interbank market, with daily transactions initially averaging about USD 3 million. In 1997, because of the pressure to devaluation of domestic currency under the influences of the Asian financial crisis, SBV again undertook a stronger measure in the reforming process: eliminating the official reference exchange rate, in stead of that the SBV allowed commercial banks to trade in the maximum margin of 0.1% on the either side of the closing-rate of the latest session in the foreign interbank market.

Thus, Viet Nam gradually has moved from the fix exchange rate to peg exchange rate regime. It could be appreciated about the reforming progress in foreign exchange control as followings: First, with the devaluation of domestic currency and maximum margin controlling for foreign exchange rate in trading transactions, in an efforts to decline the inflation rate, Viet Nam not only has restored the competitiveness in the international market, but also has created the favourable environments for setting up the official foreign exchange market. Second, the step by step movements from the fix exchange rate to the peg exchange rate regime substantially has limited the negative effects resulted from the fluctuations of vehicle foreign currencies in international markets, particularly the influences of the Asian financial crisis on the very exchange rate elastic market as Viet Nam. Third, the improvements in foreign exchange control has been coincided with the economic- social stabilisation process, gradually adapting the market-oriented laws to promote the foreign investment and bolster the growth rate of the economy.

Securities market

The Treasury bills and bonds market was set up in 1995, taking in the form of bidding for the yield based on estimated volume. Since 1997, auctioning of Treasury securities became more frequent and active with both numbers of participants and bidding amounts. From May 1997, auctions were conducted weakly. The participants of the Treasury securities market mainly are state owned commercial banks, joint stock banks and insurance companies in which the state-owned commercial banks are dominant in both amounts of registration and successful bidding.

Until 2000, the secondary market for corporate shares and bonds has not set up. The necessary conditions to operate the first secondary securities market in Viet Nam has been prepared for several years. The development of favoured environment for market operation closed the progress of state owned enterprises (SOE) equitization. The Decree number 48/1988/ND-CP of the Government on securities and the securities market issued in mid- July 1998 can be regarded as the basic legal framework for the operations of the securities market. The State Securities Commission (SSC) has been directly responsible for the establishment and governance the securities industry in Viet Nam. All shares and bonds issued in Viet Nam are to be denominated in the local currency, VND. Listing candidates are likely to be selected, initially from the SOEs that have been fully equitized, and then from joint stock companies. Two Securities central in Hochiminh city and Hanoi have been established by the Decision number 127/1998/QD-TTg of the Prime Minister, and they have officially operated from mid-2000.

In summary, the securities market can be regarded as a part of financial system in Viet Nam through which enterprises can mobilise the funds for the long-term investment projects in the future.

1. The relationships exist among the credit market, foreign exchange market and securities market.

The relationship exists among the credit market, foreign exchange market and securities market was formed from the fund flows which move from one market to another ones. In other word, the change in this market will effects the flow of fund between this market to another ones, influence the relationship between funds supply and demand in those markets and finally lead to a change in the indicators reflecting the operation in concerned market. This part of paper will present the relationship exist among credit market, foreign exchange market and securities market in Viet Nam.

Financial market can be regarded as a channel to transfer funds from surplus sectors to deficit sectors. Naturally the change in the financial market are resulted from the change in flows of fund and vice versa. The characteristics of the change in funds flows heavily depends on the feature of the economy and the favourable forms in which economic agents and individuals wish to hold their surplus money. In Viet Nam, to date the common forms in which the economic agents and individuals have preferred holding their moneys are cash, bank deposits, gold and vehicle foreign currencies (usually in USD). The securities market has just developed at the primitive level, another financial assets are poor since they basically are Treasury bills and bonds. Thus, the flows of fund invest to the securities market and another financial assets are very weak and insignificant. The common approaches are the funds flow between credit market and foreign exchange market in order to gain benefits and to avoid risks. Those flows of fund lead to a close relationship between credit market and foreign exchange market clearly.

In the former centrally planing economy, the activities of credit market were limited. The demand for bank deposits was extremely low. Unless the requirements that all state owned enterprises must deposit all their money into bank accounts, private sectors and individuals all chose the other form such as gold, foreign currency and valuable assets to hold their money, in order to protect the purchasing power from the downward trend in valuation of domestic currency. In addition, most of the credit finance was allocated into the state owned sector, since the SOEs were regarded as the dominant and basic element of the economy. The credit market therefore operates poorly with the limited debtors and depositors.

Until the financial system reform took place, the official foreign exchange market had served for limited traders who were allowed by regulation to operate in foreign trade with a fixed- multiple exchange rate regime for different trade transactions. However, because of the favourable form of foreign currencies that individuals and economic agents wish to hold their money, the parallel market operated actively and strongly. This market met the needs of illegal foreign exchange transactions. High degree of dollarization is the most visible phenomenon in financial market in Viet Nam. Foreign exchange transactions took place daily with a large amount, outside the government controlling at the rate that was much higher than the official reference rate published by the SBV. Clearly, dollarization has been an economical phenomenon and popular habits for a long time.

The link between the credit market and foreign exchange market forms through two basic variables: interest rate and exchange rate. The change in interest rate in credit market may lead to a change in the flows of funds affecting the relationships between demand and supply in the credit market and thereafter in the foreign exchange market, in turn causing a change in foreign exchange rate. The following observation made from 1993 to 1999 gives the evidence of the interrelation between credit market and foreign exchange market, through the substantial change in foreign exchange rate in different periods.

The general approach of nominal interest rate in the observed time was adjusted going down, matching with the declining inflation rate. The movement of foreign exchange rate also was appreciated as stable approach after the devaluation in local currency in 1989, 1990 and 1991. In 1994-1996, VND faced the pressure to the appreciation. From 1997, the valuation of VND tended to decline with the insignificant speed.

The fluctuation of exchange rate happened in 1996-1997 resulted from the trend of interest rate in credit market. After the reform in interest rate policy, in the effort to attract surplus funds into the banking system, deposits interest rate has been maintained at the substantially high level, even higher than the average level in the world and regional markets. Under the circumstance that the VND tend to be appreciated, the difference in interest rate between international and domestic markets led to the strong incentives among domestic enterprises to import by opening of deferred letter of credit with commercial banks. The gap between international and domestic interest rates and the appreciation in VND actually created a great benefit from import goods and abroad lending. Even though at the same time Viet Nam has maintained some certain restrictions in current account and capital account, but the flows of fund from abroad and foreign trade lending has been outside those restrictions. As a result, in 1996 the trade deficit was at alarming level in which import through deferred letter of credits amount to substantial level (in 1995, imports through deferred letter of credits amount to 18% in total imports).

Those L/C was due at the end 1996 and beginning 1997. Thus there were an abnormal increase in demand for foreign exchange in market to meet the needs for L/C maturated, leading a pressure to the depreciation of domestic currency. To solve this problem, the SBV had to broaden the band between selling and buying rate of foreign exchange from 1% to 5% since 27th, February 1997. The increase in foreign exchange rate of VND/USD in turn made a negative effect on the credit market, since the indebted importers faced the consequence that they are not able to pay their debt when it dues with the great loss caused by the increase in foreign exchange rate. The weakness in the banking system also made the problem even more serious. A number of commercial banks allowed enterprises to open the deferred letter of credit without considering the financial abilities of the enterprises to pay the debts as well as the concerning trade risks. A number of enterprises that import goods through deferred letters of credit were not able to repay their debts to the bank when those letters of credit was due, contributed to raise the amounts of bad loans and non-performing loans in many commercial banks.

The change in credit market and foreign exchange market in 1999-2000 also came from the similar causes— the gap between interest rates in international market and domestic market. Until June 2000, during over one year, the Fed has raised the interest rate six times. According to that, European Central bank ECB also raised their interest rate, then the interest rate in another international interbank markets increased. Under this trend of international interest rate, commercial banks in Viet Nam gradually increased their interest rate to attract foreign currencies into bank accounts. However, lending rate could not be raised accordingly, because of the interest rate ceiling regulated by the SBV. Moreover, the domestic credit market seems to be frozen and the investment absorption of the economy is very weak. Commercial banks are too difficult to extend credit to the economy. In 1998, many commercial banks faced the accumulation of excess liquidity, since the rate of capital mobilisation is substantially higher than the rate of credit extending. Many commercial banks has no choice but continually declining the lending interest rate in attempt to extend the credit operations and drain their excess liquidity. This tendency lead to a large gap between VND and USD deposit interest rate in the credit market as well as to the flows of fund transferring from VND into USD. Though the current foreign exchange control restrict a certain transactions that are allowed to trade in USD, in fact there were a large amounts of VND drawled from bank deposits, transfer into USD and then deposit again into bank accounts in USD in order to gain the benefit from higher interest rate. USD mobilised funds increased dramatically in many commercial banks. In the other side, despite of the increase in USD interest rate, domestic interest rate in USD was still lower than that in international markets (about 1.4-1.8% at the beginning of 2000). Using mobilised funds in USD in domestic market to deposit abroad became profitable activities for commercial banks. Demand for foreign exchange in market therefore increased strongly with which exchange rate between VND/USD tended to be raised.

In summary, interest rate and exchange rate are two variables that related closely each other through the flows of funds, forming the linkage between supply and demand in credit market and foreign exchange market. With high degree of dollarization, the relationship between demand and supply in foreign exchange market is very sensitive to the change in exchange rate. The change in foreign exchange market in turn directly affects on relation between demand and supply in the credit market, and then makes a change in interest rate. On the contrary, the change in interest rate also leads to a change in flows of funds, affecting the demand and supply in foreign exchange market, and in turns changing exchange rate.

Another relation that can be taken into consideration is arising with the establishment of securities market of which the primitive form is treasury bill and bonds market. The establishment of treasury securities market was the solution to drain the excess liquidity in many commercial banks under the circumstance of credit rationing. With the absence of secondary securities market, treasury securities were traded in the primary market and they have been too difficult to be sold for public though commercial banks were allowed to do that. In fact, commercial bank could only sell those treasury securities for the SBV to liquidate.

Table 1 Operation of Treasury securities market

(in million VND)

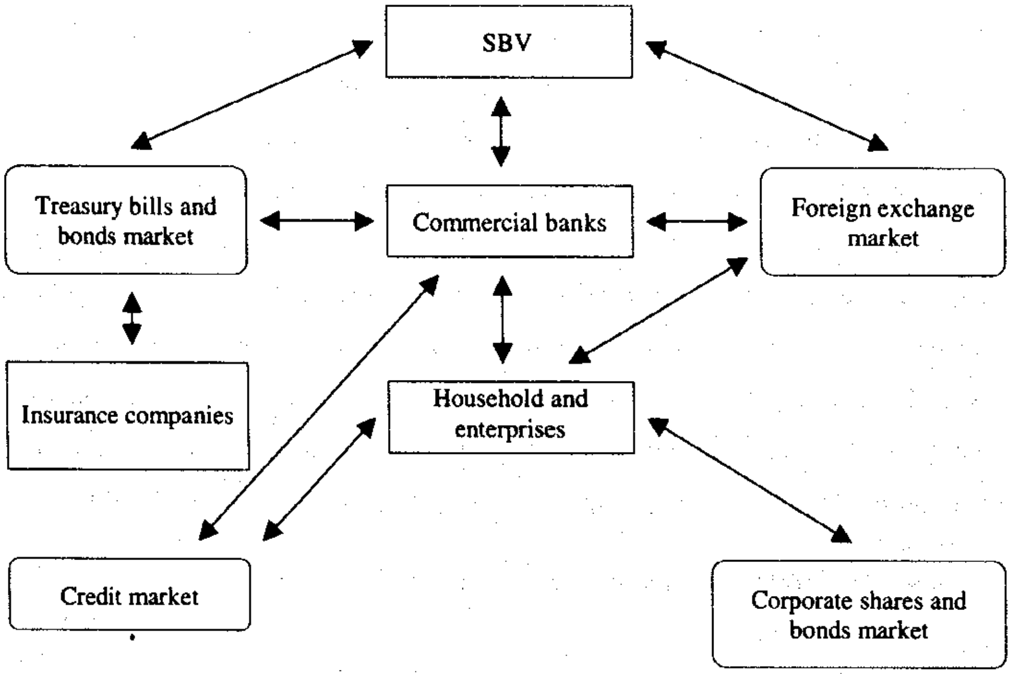
Year	Amounts auction	Amounts registration	% registration/ auction	Successful bids	% successful bids/ registration	Annually average cut off yield
1995	3598.3			976.4		
1996	4190.0	8171.1	195%	2917.5	35%	8.10%
1997	5130.0	6371.2	124%	4020.7	63%	10.20%
1998	4400.0	6364.5	190%	3011.6	36%	11.64%
1999	3650.0	8240.0	225%	3218.0	39%	8.95%

The linkage between the credit market and T-securities market is formed through interest rate and the financial assets liquidity traded in the markets. Until now, one of the main reasons why the T- securities market has not attracted commercial bank to invest is the difficulty in mobilising long term capital in the market whereas T- securities maturates usually are over one year and low liquidated.

From the observation in the operation of treasury securities market from 1995-1999 (see table 1), it can be seen that the amount of successful bids increased, reached a peak in 1998 and then decreased in 1999. In 1998, the auction yield increased dramatically, thus the amounts of successful bids was substantially large though the amounts of registration was at the lowest level during 1996-1999. The attention on T-bills and bonds auction soared in 1998, 1999 with the amounts of registration equal to 190% and 225% of the auction amounts per year, partly because of the frozen credit market and the accumulation of excess liquidity in those years.

The link between T-securities market and foreign exchange market was formed indirectly through credit market, since the participants in T- securities market are state owned commercial banks, joint stock banks and insurance companies whose investment decisions affects on the activities of the credit market. Treasury bills and bonds have not already sold to the public until the secondary securities market operates.

Figure 1 The participants of credit market, foreign exchange market and securities market.



2. The relationships exist among money supply, interest rate and exchange rate.

Viet Nam has been defined as an open economy from the mid-1980s and she depends on the international market as a small economy. For a long time pursuing a fixed exchange rate regime with the strict foreign exchange control, the official exchange rate proclaimed by the SBV was much far from the real exchange rate in curb market. After the devaluation occurred in 1988-1991, from the end of 1991 the official exchange rate defined by the SBV was closer the rate in parallel market, in line with the relation between foreign exchange supply and demand. In 1992, the foreign exchange rate was stabilised and insignificantly fluctuated. This section of paper will present the relationships exist among money supply, interest rate and foreign exchange rate under a small and open economy with an exchange rate regime managed by the SBV during observation period 1993-1999.

To clarify those relationships, this section will use two basic indicators of money supply: Reserve money of the balance sheet of monetary authority RM and total liquidity (or broad money) M2 of the monetary survey.

The relationship among reserve money RM, interest rate and foreign exchange rate.

In the progress of economic reform, in the effort to decline the inflation rate, the SBV pursued a tight monetary policy in which the growth rate of reserve money was maintained at the low level, especially during 1995-1998 (the growth rate of RM about 8-20%). It can be seen in table 2, the net foreign asset in SBV balance sheet is important source that lead to an increase in RM. On the contrary, net credit to the economy, especially net claim on government is the elements that makes a decrease in the growth rate of RM.

Table 2 Contribution of different components on the growth rate of RM

Year	1993	1994	1995	1996	1997	1998
Net foreign assets	12%	19%	11%	17%	8%	48%
Net domestic assets	18%	-6%	9%	-6%	0%	2%
Net credit to the economy	-19%	-8%	12%	-6%	5%	-6%
Net claim on the Govt.	-24%	-4%	8%	-4%	6%	-16%
Net claim on deposit money banks	5%	-4%	3%	-3%	-1%	10%
Net other items	37%	2%	-3%	1%	-5%	8%
Growth rate of RM	30%	12%	20%	11%	8%	50%

The relationship between reserve money and interest rate

The relationship between reserve money and interest rate did not move as the expected trend. If pursuing the tight monetary policy, the interest rate tends to be raised. Actually, interest rate in credit market was adjusted downward. This approach arises from the operational features of credit market in Viet Nam as followings:

Firstly, interest rate in the banking system was not adjusted by the relationships between demand and supply in the credit market, and they did not reflect the relation between liquidity demand and supply in money market. Actually, when facing the excess liquidity, commercial banks could not actively adjust the lending interest rate to the desirable levels because of the interest rate ceiling. Despite the official interest rate published by the SBV has been adjusted frequently in line with the market signal, but it usually has been imposed administratively on deposit money banks, and it has been considered with the targets to promote investment demand and to bolster the growth rate.

Secondly, credit expansion or contraction was not completely decided by the change in interest rate. Credit ceiling has been regarded as an effective instrument to restrict the undesirable growth rate of credits to the economy until 1998. Therefore, the credit ceiling played the decisive role to compress or expand the credits to the economy.

Thirdly, there are another credit rationing originated from the economy that cause the distortion in the relationships between credits and interest rate, even without credit ceiling and interest rate ceiling. Those lied in the restriction of current lending regulation in commercial banks, for example problem of the collateral, land using rights...In addition to that, the existence of privileged interest rate for state- planning infrastructures investments caused the distortion in credit allocation in the market. Under the influence of bankruptcies of some enterprises and a number of collapses in credit operations in 1996, 1997, the credit market became more risky. Commercial banks were reluctant to offer new loans even though they were able to do that and hence to avoid taking more risks, because commercial banks generally lacked the necessary information about the creditworthiness of their customers, and it was too difficult to appraise the market risk exactly.

The relationship between reserve money and exchange rate

In theory, the mechanism to channel the change in money reserve to the exchange rate can be formed by two ways: The first, by indirect mechanism through the credit market. In conducting an expansionary monetary policy, the central bank increase the growth rate of reserve money by the increase in net credit to the economy, raising supply of credits and declining interest rate. In the developing economy with the assumption that the absorption of the economy is high, a falling in interest rate will encourage the domestic investment demand, raising the aggregate demand in the economy as well as increasing demand for import goods, particularly in a developing country the share of material, equipment and machines in total imports usually is high. The balance of payment tends to be deficit, making a pressure to the domestic currency depreciation.

The second, through direct mechanism if the expansionary monetary policy is conducted through foreign exchange market. The central bank can pump money in to circulation by selling domestic currency and buying foreign currency in the market, raising the demand for foreign exchange and making the pressure to domestic currency depreciation.

With the feature of the interest rate control and monetary policy instruments in Viet Nam, the first mechanism to transmit the change in reserve money to the change in foreign exchange rate seem not to be clear. The second mechanism will be observed in more detail in the period from 1993 to 1999.

In the observed time, the net foreign assets of the SBV went up rapidly, especially in 1994 (increased by 51%), 1995 (67.71%), 1997 (38.12%) and 1999 (84.41%). The growth in net foreign assets was the major source making an increase in reserve money during 1994-1999 (see table 2). The SBV has bought a large amount of foreign currencies in order to raise the foreign reserve whereas the foreign exchange rate was maintained stabilisation, even VND tended to be appreciated in 1994, 1995 and 1996.

In 1994, 1995, the trend of foreign exchange supply and demand altered dramatically: from the position that supply of foreign exchange exceeded demand for foreign exchange in 1990- 1991, in 1994-1995 foreign exchange supply was mach higher than its demand in the market. This trend originated from the reform in foreign exchange control approaching to liberalisation. A large amount of foreign exchange floating in parallel market was attracted into the banking system. The flows of foreign currencies from abroad residents also increased. Domestic interest rate of USD was allowed to be higher than that in the international market. VND faced the pressure to appreciation, though current account was deficit. The intervene of the SBV was implemented by buying the foreign currencies in order to restore the equilibrium in foreign exchange market and avoid domestic currency appreciation, raising the foreign reserve for the SBV. To support the foreign exchange rate policy, another measures in foreign exchange control also was applied, for example from October 1994, the government narrowed the scope in trading and services for foreign currency in cash in Viet Nam. The SBV attempted to decline the interest rate in VND in order to restrict the flows of fund transferring from foreign currencies into VND, as well as to control and limit the trading loans from abroad, particularly for deferred letter of credit with the proportion of money deposit for security amount to 80% of total L/C value from previous proportion of 20%.

The similar change for the reserve money occurred in 1999 with a strong increase in net foreign assets whereas the foreign exchange rate fluctuated insignificantly. The supply of foreign exchange went up, because in 1999 the current account altered to be surplus after a decade of deficit. The SBV also change the control measures, mechanism and policies on foreign exchange: declined the surrender requirement from 80% to 50%, the flow of foreign currencies from abroad residents also increased. Interbank market for foreign exchange operated actively, with the supply of foreign exchange often exceed the demand for foreign exchange. Reserve money was raised by 50% in 1999 in which net foreign assets increased by 50% compared with 1998, weighting 48% in the growth rate of reserve money (see table 2). Moreover, it can be seen that the SBV pump a substantial amount of money to raise the foreign reserve, since currency in circulation increased by 58.96% compare with 1998.

From above observation, it can be seen that the relation between reserve money, particularly the net foreign assets and exchange rate is not very clear. The change in the structure of SBV reserve money and the upward trend in net foreign assets gives the evidence that the intervention of the SBV took place actively when the supply of foreign exchange exceed the demand for foreign exchange. The actions of the SBV contributed to restore new equilibrium in foreign exchange market and hold exchange rate stabilisation under the influence of changes in demand and supply. However it is too difficult to assess the degree and abilities of the SBV in affecting on movement trend of foreign exchange rate, since the SBV intervention in the market often took place beside the progress of reform in foreign exchange control. Moreover, the intervention of the SBV implemented when VND faced the pressure to appreciation. This is inside ability of the SBV. But it is too difficult to give similar conclusion if VND face the pressure to depreciation, since it depends on the strength of the SBV foreign reserve.

The relationship among broad money, interest rate and foreign exchange rate

Broad money M2 can be regarded as a main indicator of money supply especially with the target on curbing inflation of the SBV, because of the close relationship between the growth rate of broad money and inflation rate in Viet Nam. The following part will present the relationships exist broad money, interest rate and foreign exchange rate.

It can be seen in more detail the change in structure of broad money M2 in recent years as followings:

Table 3 The change in structure of broad money M2 (1990-1999)

Year	M0/M2	M1/M2	Foreign deposits/M2
1990	0.33	0.47	0.32
1991	0.32	0.45	0.41
1992	0.39	0.55	0.30
1993	0.44	0.59	0.23
1994	0.43	0.50	0.22
1995	0.36	0.50	0.21
1996	0.35	0.52	0.20
1997	0.30	0.49	0.23
1998	0.27	0.45	0.25
1999	0.29	0.45	0.26

- M0 is a quite large component in broad money M2 (amount to 44% in total in 1993) (see table 3). Most of M0 circulates outside the banking system, meets the demands for retail trade of consumer goods, farming products and foods. This component in broad money has been tended to go down in proportion in line with the progress of the development of the banking system and financial deepening of the economy.
- Demand deposits (M1-M0) are used to meet the needs for payments transactions among economic agents and individuals in the economy. In the transitional process of the economy, this component of broad money has changed with the stable trend, depending on the fluctuation of the trading, business activities and production cycles as well as the capacity of the banking system to meet the demands for payment transaction.
- Time and saving deposits, commercial bank bills and bonds has changed with the upward trend in structure of broad money, matching with the domestic currency stabilisation progress, the development of banking system and the creation of new financial assets.
- Foreign currency deposits amounted to considerable proportion in broad money, reflecting the degree of dollarization in Viet Nam financial market. The proportion of foreign currency deposits in the banking system reached the peak in 1994 (amount to 41% in broad money) when there was a fever of foreign exchange in the market, pushing the foreign exchange rate up strongly.

Making analysis the elements affecting on the growth rate of broad money from the assets side in 1990-1999, it can be seen that two major elements that are the most important elements to contribute to the growth rate of broad money are net foreign assets and net credit to the economy. The change in net claim on the government has no significant effect on the broad money growth rate, since providing credit for budget deficit was limited from the beginning of the financial system reform progress. The figures in table 4 shows the weighted contributions of various assets items on the growth rate of broad money in the monetary survey during 1990-1999.

Table 4 Contribution of various asset items to the growth of broad money (1991-1999)

Items	1991	1992	1993	1994	1995	1996	1997	1998	1999
Net foreign assets	52%	10%	-16%	2%	9%	6%	10%	13%	30%
Net claim on govt.	-1%	-10%	7%	2%	1%	-1%	0%	3%	-4%
Net credit to the economy	44%	34%	28%	32%	16%	16%	18%	13%	14%
Net other items	-16%	0%	0%	-3%	-4%	1%	-2%	-4%	1%
Annual growth rate of M2	79%	34%	19%	33%	23%	23%	26%	24%	41%

The relationship between broad money and interest rate

During 1990-1999 broad money increased with the decreasing rate, from the unstable trend in 1990-1994 to the stable trend in 1995-1998. This approach of growth rate of broad money gives the evidence that favour the tight monetary policy that the SBV has pursued from the beginning of 1990s. Until 1998, the growth rate of broad money has been restricted directly by the credit-ceiling instrument, especially in 1992, 1993 and 1994. In addition to that, interest rate ceiling also has been maintained administratively until the beginning of 2000. Therefore, the relationship between broad money and interest rate has not been formed completely. The following section will make an observation about the relationship between broad money and interest rate under the direct intervention from the SBV on both with the time of observation in 1990-1999.

From 1992-1994, with the first steps on the progress of financial sectors reform, the supply of credit in the banking system increased strongly as a result from the increase in the flows of fund in VND as well as in USD into commercial banks. Whereas under the influence of the downward trend in nominal banking interest rate, net credit to economy rose dramatically. The increase in net credit to the economy was the main factor that led to the increase in the growth rate of broad money (see table 4). Credit ceiling was used as a basic monetary policy instrument with the various ceiling allocated to every commercial bank in order to limit the excess growth rate of credit to the economy in curbing inflation.

From 1995-1996, the growth rate of broad money approached with the stable trend. The increase in broad money was kept in line with the target in curbing inflation, and to bolster the growth rate of the economy. Although the credit to the economy was not the factor that led to the increase in the growth rate of broad money, it still played the key role in the growth rate of broad money. In 1997-1998, the growth of economy showed the signal of stagnation, credit market seemed to be frozen because of the weakness in absorption of the economy. Using the credit ceiling to conduct monetary policy was terminated since 1998 when it no longer operated effectively. Moreover, the SBV steadily declined the interest rate ceiling in 1997, 1998 and 1999 in attempt to bolster the economic growth rate. The downward trend in interest rate was implemented beside a number of reforms in the current lending mechanism. However, above reforms seemed to be not bring the expected results since the economy needed stronger and sharper reforms from economic structure. The influences of the downward trend in interest rate on broad money in this period were very weak.

Summarily, the relationship between broad money and interest rate in financial market of Viet Nam has been formed incompletely and it is too difficult to quantify this relation with the absence of market mechanism to transmit the change from interest rate to broad money and vice versa. However, in considering this relationship under direct intervention of the SBV, it can be concluded as follows: During 1991-1994, downward trend in interest rate has had substantial effects on the growth rate of broad money, through the increase in net credit to the economy. On the contrary, from 1997-1999, the downward trend has very weakly influenced on the growth rate of broad money because of frozen domestic credit market.

The relationships between broad money and foreign exchange rate

To analyse the relationships between broad money and foreign exchange rate, the following section will use the figures and real life change during 1991–1999 to illustrate. This section focuses on the changes in 1991 and 1999 when there were the certain fluctuations in foreign exchange rate and broad money.

In 1991, the domestic currency was devalued strongly. This change originated from the distortion occurred before, since the nominal foreign exchange rate was maintained at a fixed rate. Official foreign exchange rate separated from its real rate in parallel market. VND was overvalued by the SBV, causing a great benefit for importers and the same loss for exporters and making a serious disequilibrium between demand and supply in foreign exchange market. The change in Northern of European market also declined the flows of foreign currency from the SEV group whereas the demand for foreign exchange to import the material, machines and equipments increased rapidly. VND faced the strong pressure to the devaluation. Even though the SBV under took a number of reforms in foreign exchange control, but the trend of devaluation in domestic currency was unavoidable and the SBV had to adjust the foreign exchange rate up gradually. In 1991, the official foreign exchange rate increased by 84%. Finally, the nominal official value of domestic currency was increased to its real value in the market. Due to the expectation in the increasing trend of foreign exchange rate, a large amounts of VND was transfer in to USD. The foreign currency deposits soared. Commercial banks held a large amount of USD, pushing up the proportion of foreign assets in total assets of the banking system. It can be seen in table 4, net foreign assets weighted 52% in the growth rate of 79% of broad money in 1991. By administrative measures in foreign exchange control to limit the using foreign currency in transactions, the SBV attempted to stamp out the fever on foreign exchange in the market in 1991. In 1992, foreign exchange moved to the stabilised trend. This trend continued through the years after (in 1992, the change in foreign exchange rate was -9.8%; 1993:

+3.7%, 1994: +1.8%).

In line with the downward trend in foreign exchange rate, the net foreign assets in commercial banks felt down, leading to a decrease in growth rate of broad money, particularly in 1993 (weighted to the growth rate of broad money -16%) (see table 4). In 1995-1997, foreign exchange rate continued to maintain stabilised. Accordingly, net foreign assets in the banking system rose inconsiderably. Unless the intervention of the SBV aiming to avoid the appreciation in domestic currency, net foreign assets in commercial banks were maintained at the reasonable level in line with the targets in their business with a sound and stable growth rate.

In 1997, under the influence of fluctuation in relation between supply and demand in foreign exchange market (to meet the needs of L/C maturated) and certain effects of the regional financial crisis, there was the pressure to depreciation of domestic currency. A number of adjustments in exchange rate control were undertaken by the SBV, as a result, domestic currency depreciated insignificantly. In 1999, net foreign assets in the banking system soared by 94% compared with 1998. The growth rate of broad money was 42%. This was the highest rate from 1992 in which net foreign assets weighted 30% in 42% of total growth rate. Analysing the structure of broad money from the liabilities side of the monetary survey, it can bee seen that the value of foreign deposits increased by 54.49% compared with 1998—that was the highest growth rate from 1992. The reason of this change did not come from the fluctuation in foreign exchange rate as happened in 1991, but originated from the gap between domestic and international interest rates. Due to the increase in USD in the international market, commercial banks accelerated the foreign currency mobilisation in domestic market to deposit into foreign banks in order to gain the benefit from the international higher interest rate while the domestic credit market was likely to be frozen. The demand for foreign exchange rose and its rate tended to be pushed up.

Summarily it can be concluded about the relationships between foreign exchange rate and broad money as followings: The first, relationship between broad money and foreign exchange rate is quite clear in the short run: A rise in foreign exchange rate leads to a rise in broad money through the rise in net foreign assets in the banking system. On the contrary, a rise in net foreign assets in the banking system affects to the demand for foreign exchange, causing a rise in foreign exchange rate in the market. The second, the movement of foreign exchange rate in long run matched with the expected trend when central bank pursue a tight monetary policy in which the valuation of domestic currency would be appreciated. However, this relationship seem to be neither stable nor completely effected by the intervention of the SBV by buying or selling foreign exchange in the market. Actually, this relation was affected heavily by the change in measures, mechanism, regulations and rules in foreign exchange control and exchange rate policy of the SBV in the progress of financial reform.

3. The predicted changes in the relationships among credit market, foreign exchange market and securities markets in progress of financial sector reform

The progress of the financial sector reform in Viet Nam will take place in the next years with the main following contents:

- Develop the securities market including primary and secondary markets. This development will be completed with the progress of equitization of state-owned enterprises.
- In foreign exchange market, the SBV will encourage commercial banks to develop new operations such as Forward Swap, Option. The SBV gradually liberate the foreign exchange rate, allow the foreign exchange rate to be adjusted according to the relation between supply and demand in the market.
- In line with the progress of financial system reform, the SBV will research and allow applying new financial assets in order to strongly develop the monetary markets. Treasury bills and bonds will play a more active role in adjusting interest rate to the economy by market mechanism.
- The basic monetary policy instruments will be indirect and market oriented ones which can be used actively, frequently and flexibly to intervene in the market in conducting the monetary policy. The use of direct monetary policy instruments such as credit ceiling, interest rate ceiling has been terminated. With the "basic interest rate controlling mechanism" the SBV has already controlled the interest rate according to the relation between credit supply and demand in the market.
- With above stages in financial sector reform, the flows of fund move among credit market, foreign exchange market and securities market will change. Any change in one market will quickly lead to another change in the other markets, forming the interrelation among them.

In stead of concentrating all flows of funds into the banking system ore speculating in foreign exchange market in order to protect the purchasing power of money, a part of the surplus funds will be invested directly to joint stock enterprises through securities market in the form of corporate shares and bonds. The improvement of the secondary market will speed up the progress of equitization of state-owned enterprises.

The existence of the securities market will affect strongly to the credit market through the qualifying relations as follows: The first, an efficient secondary market will provide the market indicators and information about the customers through which commercial banks can define exactly the creditworthiness and risk in credit operation, accordingly to decide to invest into credit market or into securities, diversifying the credit risks. The second, in order to attract flows of fund in securities market, enterprises will improve their profitability and efficiency. Therefore the risk of those enterprises will be reduced, accordingly commercial banks are able to reduce their non-performing loans in the credit market. The third, with the capital mobilisation in securities market, the credits will not is the unique source to finance the deficit of fund in enterprises, market risk therefore will be reduced for commercial banks. The fourth, with the appearance of a number of financial assets that can be trade flexibly in the market, commercial banks will be active in conducting their liquidity, improving the efficiency and flexibility in liquidity management.

The other that can be taken into account will be defined in the progress of financial reform in the next future: the relationships among interest rate, price of securities and interest rate of securities. A rise in bank interest rate will attract flows of fund into the banking system, reducing the demand for securities as well as reducing the price of securities. Accordingly, interest rate of securities will rise. On the contrary, a fall in price of securities will make a rise in interest rate of securities, causing the similar effects on the credit market through the flows of fund to move between credit market and securities market.

Interest rate in domestic market and international market will be closely related, through the change in foreign exchange rate in the market. If the interest rate in domestic financial market is higher than that in the same risky international markets, there will be an increase in capital inflows from abroad to gain profitable investment opportunities in domestic securities, causing an increase in demand for domestic currency and the pressure to appreciation. The growth of capital inflows can make price of securities increasing and interest rate of securities decreasing. Under the change in flows of fund between credit market and securities market, the bank interest rate will be adjusted downward.

Alternatively, the change in domestic currency with the downward trend in value will affect on the credit market and securities market through the change in flows of fund because of expected devaluation. Capital outflows will rise. This approach will lead to a reduction in demand for securities in the domestic financial market, pushing the price of domestic securities down and interest rate of securities up. This change in turn will lead to an increase in flows of fund from the credit market to gain profitability, accordingly bank interest rate will also increase.

In summary, the change in the relationships among the credit market, foreign exchange market and securities market can be defined as follows: First, the flows of fund will be more sensitive to the change in interest rate and foreign exchange rate and vice versa, forming the closer links among those above markets. Second, domestic financial market will be more sensitive to the change in the international market, therefore the consequences from the external influence on domestic financial market will happen more quickly and complexly. The ability to intervene of the SBV depends on the strength and confidence of the banking system and financial system as well as the completeness of the concerning legal framework.

The relationship among money supply, interest rate and foreign exchange rate

Monetary policy continues to be implemented targeting on the domestic price stabilisation. The use of direct monetary policy instruments such as credit ceiling, interest rate ceiling will be eliminated. "Basic interest rate controlling mechanism" has been used by the SBV from the mid-2000 according to which, the interest rate is adjusted frequently and published in line with the relation between demand and supply in credit market. Indirect and oriented market based instruments such as open market operation has already applied from 12 July 2000. The Law of State Bank of Viet Nam defined OMOs as the operations in selling and buying the short-term securities implemented by the SBV conducting national monetary policy. Through OMO, the SBV increases money supply by buying securities and reduces money supply by selling securities in the monetary market.

Therefore, it can be predicted the relationship between reserve money and interest rate when the financial system develop at a higher level through a market based mechanism as followings: The increase in money supply implemented by the SBV will affect on the relation between liquidity demand and supply in the banking system. If there is excess liquidity in commercial banks, through the market mechanism the interest rate will go down. The decrease in interest rate will influence the activities of securities market: price of securities will be pushed up, demand for investment will be encouraged, and accordingly the aggregate demand and import demand will increase. The capital outflows will rise because of the downward trend in domestic interest rate, effecting the deficit in current account and capital account balance and pressure to depreciation of domestic currency. Thus, the ability to control the monetary policy in line with the target of the SBV depends heavily on the creditability and precision of the forecast about reserve supply and demand in the banking system according to which the SBV is able to make suitable, sound and desirable decision when making intervention in monetary market.

The relationships among broad money, interest rate and foreign exchange rate

Foreign exchange rate stabilisation will be the basic goal in foreign exchange control and exchange rate policy of the SBV. With this approach, it can be predicted that the relationships among broad money, interest rate and foreign exchange rate in the short run is quite clear. In accordance with the reform directing to the liberalisation in foreign exchange control and exchange rate policy with integrated approach, capital inflow and outflows will substantially affect foreign exchange rate and vice versa. This is anticipated tendency when the foreign exchange market develops to the higher level and the convertibility of VND is improved. Foreign exchange rate become even more sensitive to the change in foreign exchange market when the trade in foreign exchange can be implemented easily and flexibly through many types of trading contracts in derivatives. The upward trend in the exchange rate elasticity of capital flows requires the central bank to intervene actively in market by buying or selling foreign exchange to stabilise the exchange rate and restore the external equilibrium in the market.

To restore the internal equilibrium, the next step should be undertaken by the central bank to control the growth rate of broad money in domestic market targeting on stabilisation of domestic price level. Sterilisation of capital flows should be possible. In principle, with the appearance of the secondary security market, the SBV can implement the sterilisation policy through the securities market by selling or buying treasury or central bank bills and bonds. However, imperfect capital market in Viet Nam as many emerging economies, this sterilisation should be taken in to consideration some effects on interest rate and foreign exchange rate when controlling the growth rate of broad money. Government must issue more paper to sterilise capital inflows, if foreign demand is initially for other forms of domestic assets, real interest rate may rise to the higher rate than expected one. While higher interest rate might be thought disinflationary in themselves, they may in turn attract more foreign capital, which further enhances the likelihood of unsterilized intervention and an undesired expansion of credit to the economy and uncontrollable growth rate of broad money. This may well be the case in many emerging economies such as some Asian countries. The confidence effects, which contribute to large capital inflows, can also lead to a sharp increase in the demand for credit even at higher nominal interest rate. Thailand may be seen as an example: the demand for credit to invest in property, shares and fixes capital was increased undesirably. This contribute to overheat the credit market and cause the financial crisis in the mid 1997 in Asian region.

In summary, from analysing the relationships among interest rate, foreign exchange rate and broad money, it can be seen that: With the progress in the liberalisation of interest rate control, the relationship exist among interest rate, foreign exchange rate and broad money will be closer and more complexly. This shows the importance of the stabilisation in domestic price level. The level of interest rate should be regarded by the SBV as market indicators in reflecting the activities in money market and domestic investment demand and supply, accordingly to define the suitable target in conducting monetary policy.

4. Proposed coordination in the regulations among credit market, foreign exchange market and securities markets

The continued reform approaching to liberalisation is the necessary requirements for the government in the countries that is in transition from plan to market economy. However, the Government should establish a strong position for themselves to take the initiative in conducting the macro adjustments concerning to the operations of the financial market, making intervention timely and actively when facing the dramatic change that can effect on the change in the financial markets.

The measurers that the government should consider to strengthen the financial system

For the banking credits market, strengthening the banking activities and developing a competitive environments should be possible as the first requirements. Restructuring the banking system should be the privilege solution that Government undertakes to create a confident and healthy banking system. Insolvency commercial banks should be merged or bankrupted. The bad loans or non-performing loans should be resolved, especially the bad loans from the former state-owned enterprises.

Credit rationing should be terminated, government need to solve the problems of collateral. The direct intervention on the lending decision of commercial banks should be eliminated. The solution for remain problems in credit market should be used consistently, through exact assessments about the current situation of each commercial banks, accordingly the government support the weak bank that are still on business, as well as merge or bankrupt insolvency banks. In addition to that, the government should set up a fair competitive environment in the market for all sectors in order to standardise the banking services.

For the securities market, the operation of the securities market depends heavily on the speed of equitization of the state-owned enterprises. The progress of equitization should be implemented beside the progress of banking system restructure in order to gradually solve the bad loans from those enterprises in the banking system. The information about enterprises should be disclosed, precise in the securities market. The authority should correct the unreal information and rumour in order to avoid the abnormal change in the market. The effects of speculation in the market should be limited.

Operation of foreign exchange market should be stabilised with the foreign exchange rate policy. Until now, capital flows have still been restricted by foreign exchange control. In the future, this restriction should be terminated if SBV foreign reserve is strong enough to intervene in the market when facing the abnormal change in the demand and supply in foreign exchange market.

In summary, with the progress of financial reform approaching to liberalisation, the relationships among credit market, foreign exchange market and securities market will be formed by market mechanism. The intervention from the SBV will be indirect ones, through the market mechanism to affect on the flows and structures of fund formed in each market, in order to reach the goal of monetary policy. The ability and degree by which the SBV can influence on the market completely depends on the health and strength of the banking system, the efficiency of the securities market and foreign exchange market.

Selected information on policies and regulations affecting operations of credit markets, foreign exchange markets and securities markets

Credit operations and SBV's conduct of interest rate policy

Subject	Name of the regulations	Executive summary
Mortgage, pledge and guarantee for borrowing bank loans	SBV Governor's Decision No.217/QD-NH1 dated 17 August 1996	Promulgating Regulation on Mortgage, pledge and guarantee for borrowing bank loans
	Government's Decree No. 178/1999/ND-CP	Promulgating Regulation on auction of assets
	Government's Decree No. 86/CP dated 19 December 1996	Regarding collateral on loans from credit institutions
Long and medium-term credit operations	SBV Governor's Decision No.367/QD-NH1 dated 21 December 1995	Medium-term credit operations are those whose lending terms are from 1 year up to 3 years. Long-term credit operations are those whose lending terms are over 3 years but do not exceed the depreciable life of the assets originated from the such loans. Applied both to VND-denominated loans and foreign currency-denominated loans. The principles of credit: the borrowed funds must be used effectively in accordance with specified purposes and the repayment of principal and interest must be adequate and timely as agreed between the lender and the borrower. The maximum loan size is 70% of the value of the collateral.
	SBV Governor's Decision No.200/QD-NH1 dated 28 June 1997	Amendment of and addition to some provisions of SBV Governor's Decision No.367/QD-NH1 dated 21 December 1995, whereby revising the lending term of medium-term credit operations, long-term credit operations, conditions for borrowing funds and specifying loan size for the borrowers, and adding the stipulation on purchase and sale of loans among credit institutions.
Lending interest rates	SBV Governor's Decision No.381/QD-NH1 dated 28 December 1995	The ceiling lending interest rates charged by credit institutions with regard to economic entities and individuals: - Short-term rates: 1.75% per month (21% pa.) - Medium and long-term rates: 1.7% per month (20.4% pa.) The spread between average lending interest rate and average interest rate of mobilizing funds is 0.35% per month (4.2% pa)
	SBV Governor's Decision No.241/2000/QD-NH1 dated 2 August 2000	SBV shifts from the management mechanism of lending interest rates to the management mechanism of base interest rates with regard to VND-denominated loans and of managed market interest rates with regard to foreign currency-denominated loans The base interest rate that credit institutions charge their customers is 0.75% per month. Credit institutions, at their discretion, determine lending interest rates charged whether fixed rates or flexible rates, but lending interest rates can not exceed the base interest rate plus the following margin: - As to short-term loans: 0.3% per month - As to medium and long-term loans: 0.5% per month

Subject	Name of the regulations	Executive summary
Refinancing interest rates	SBV Governor's Decision No.244/QD-NH1 dated 1 October 1994	The refinancing interest rates that SBV charge commercial banks, development and investment bank and Agriculture Bank are 100% and 95% respectively. The refinancing proportions are computed based on the return of the project or documents applying for the refinancing facility. In special case and as being directed, the SBV Governor has separate decisions. With regard to the Gold, Silver and Precious Gemstone Corporation, the SBV extends loans in accordance with the principle of supplementing working capital and the interest rate of 1.7% per month is applied.
	SBV Governor's Decision No.40/1998/QD-NHNN1 dated 17 January 1998	The refinancing interest rates that SBV charge credit institutions is 1.1% per month
	SBV Governor's Decision No.238/2000/QD-NHNN1 dated 31 July 2000	The refinancing interest rates that SBV charge credit institutions is 0.4% per month
Short-term credit operations	SBV Governor's Decision No.198/QD-NH14 dated 16 September 1994	Promulgating Rule of short-term credit operations with regard to economic entities for supplementing shortage in working capital of the borrowing entities. The borrowing entities must be profit-making entities and have collateral or being guaranteed by the third competent party.
	SBV Governor's Decision No.199/QD-NH1 dated 28 June 1997	Amending borrowing conditions: as evaluated, the project or the loan is effective in economic sense (instead of requiring profit-making business).

Securities market

Subject	Name of the regulations	Executive summary
	Government's Decree No. 75/CP dated 28 November 1996	The Government establishes State Securities Commission for the purpose of organizing and conducting State management function over securities and securities market. The Decree provides for the duties, powers and the organizational structure of State Securities Commission
	Government's Decree No. 48/CP dated 11 July 1998	Regarding securities and securities market. This Decree provides for the public offering of securities, securities transactions and activities associated with securities and securities market within the territory of Vietnam. This Decree has 11 Chapters and 83 articles.

Foreign exchange markets

Subject	Name of the regulations	Executive summary
Exchange rates and foreign exchange trading	SBV Governor's Decision No.203/QD-NH9 dated 20 September 1994	The SBV aims to use Foreign exchange Stabilization Fund for intervening into the foreign exchange market effectively, implementing monetary policies and foreign exchange policy of the State. The trading exchange rates among interbank foreign exchange market's members are determined on the basis of official exchange rates and permissible trading bands prescribed by SBV.
	SBV Governor's Decision No.45/QD-NH dated 27 February 1997	Providing for principles of determining selling and buying exchange rates by credit institutions which are allowed to conduct foreign exchange operations. The trading band around official exchange rates announced by SBV is increased to 5% (replacing the previous band of 1%). The spreads between selling and buying exchange rates are prescribed as follows: - For transfer: 0.1% - For cash: 0.5%
	SBV Governor's Decision No.207/QD-NH7 dated 1 July 1997	Promulgating the regulation on opening letter of credit for importing goods on credit, conditions for opening deferred L/C: for short-term L/C, the incumbent enterprises must have direct import-export permission, deposit, collateral or guarantee with the maximum term of 1 year; for medium and long term L/C, the incumbent enterprises must register foreign borrowings as prescribed. The borrowing enterprises are only allowed to give collateral in the form of imported goods in cases approved by the Prime Minister
	SBV Governor's Decision No.16/1998/QD-NHNN7 dated 10 January 1998	Providing for principles of determining forward and swap exchange rate by credit institutions which are allowed to conduct forward and swap foreign exchange operations as follows: The margin over the spot rates is 1% (for 1-month term), 2% (for 2-3 month term), 1.5% (for 1-2 month term), 3% (for 4-5 month term), 3.5% (for 5-6 month term).
	SBV Governor's Decision No.65/1999/QD-NHNN7 dated 25 February 1999	Providing for principles of determining exchange rates by credit institutions which are allowed to conduct foreign exchange operations. The margin between spot exchange rate of VND vis-à-vis USD and the average interbank exchange rate of the previous day which is announced by SBV can not exceed 0.1%.
Foreign currency accounts	Prime Minister's Decision No.386/TTg dated 4 August 1994	Providing for the opening of foreign currency accounts by organizations, economic entities having foreign exchange revenues
	Government's Decree No. 63/1998/ND-CP dated17 August 1998	Providing for the foreign exchange controls in Viet Nam applied to residents and non-residents holding foreign exchange assets. The Decree has specific provisions regarding the account opening, use of foreign currencies, current transactions, capital transactions as well as foreign exchange operations made by credit institutions and foreign exchange bureaux which are previously stipulated in SBV's Decisions from time to time. In addition, the Chapter VI and Chapter VII provide for the powers and responsibilities of SBV in regulating standard gold and the exchange rates of VND vis-à-vis foreign currencies.

Interbank markets

Subject	Name of the regulations	Executive summary
SBV Bills	- SBV Governor's Decision No.211/QD-NH1 dated 22 September 1994	Regulation on the issuance of SBV bills aimed at creating instruments for conducting monetary policies from time to time. SBV bills are dominated in VND. SBV bills are sold by auction method. The expenses for issuing SBV bills and and interest expense on SBV bills are incorporated into operating expenses of SBV.
	SBV Governor's Decision No.89/QD-NH9 dated 28 March 1995	Establishing markets for trading bills among banks belonging to SBV.
Treasury Bills	SBV Governor's Decision No.61/QD-NH19 dated 8 March 1995	Promulgating Regulation on the organization of bidding of Treasury Bills. Bidding of T-Bills is the method of issuing T- Bills on a whole sale basis by means of bidding among members in the primary market of issuing T-Bills. T-Bills are issued, realized and repaid in VND. The minimum face value of T-Bills is VND1 million. Terms of T-Bills are 1-month, 3-month, 6-month and 9-month. T-Bills are issued in the forms of book entries, registered or bearer certificates. The nature of T-Bill bidding is the bidding of interest rates. The regulation has specific provisions relating to eligible bidders (article 4), participation conditions (article 5), methods, procedures, selling prices of T-Bills. In additions, the regulation specifies responsibilities and powers of Departments and subordinate entities under SBV.
	Government's Decree No. 01/2000/ND-CP dated 13 January 2000	Regulation on the issuance of Government bonds. In Chapter II, Section I, T-Bills are provided for.
Bonds	SBV Governor's Decision No.212/QD-NH1 dated 22 September 1994	Rule for the issuance of commercial banks' and development and investment bank's bonds. Bank bonds are long-term debt instruments in the capital market in the form of IOU issued by credit institution for the purpose of mobilizing funds. There are 2 types of bonds: registered bonds and bearer bonds. The terms of bank bonds are over 1 year. The interest rates of bonds are determined by banks on the basis of demand and supply of loanable funds in the credit market. The contents as well as the printing procedures of bonds are subject to the SBV's regulations. In addition, the rule also provides for the issuance, procedures for transferring the ownership of bonds issued by credit institutions.
	Government's Decree No. 23/CP dated 22 March 1995	Regarding the issuance of international bonds. International bonds are issued in order to mobilize funds in international markets for financing investment and economic development in Viet Nam. There are 3 types of international bonds: - Government bonds - Bank bonds issued by state-owned commercial banks. - Corporate bonds issued by state-owned enterprises. This Decree has specific provisions on the duties of Ministry of Finance and SBV in regulating the issuance and effective use of different types of bonds.

B－4

Financial Market and Relationship between Its Component Markets

Nguyen Son

State Securities Commission

1. The relationship between credit market, exchange market, and securities market

In the market-driven economy, the process of channelling funds from those who saved surplus funds to those who have a shortage of funds is normally performed in the financial markets. Here, the fund allocation process is done through various methods, which make the fund providers and fund seekers may directly or indirectly met through financial instruments and intermediate financial institutions such as commercial banks, financial companies, insuarance companies, investment funds, etc..

Typically, the financial markets are divided into two types of market. The first market is the monetary market which includes interbank market, exchange market and most importantly, credit market—the lending market of financial institutions. The second market is capital market, which consists of long-term financial leasing market, mortgage market and the most important market—securities market. These classifications are based on various terms that basically are considered as follows:

Firstly, in term of the maturity time of a loan, fund is separateed into short-term and long-term funds. Short-term fund is not collectively provided; it basically consists of payment means and is considered the subject of the monetary market. Long-term funds are normally put into large channels with mass volumes to satisfy demands in investments and productions. They are gathered at large trading sites and considered the main subject of the capital market.

Secondly, in term of the methods of fund mobilization, it is sorted into direct and indirect mobilization. And there are two types of market that are correspoding to these two methods, the monetary market (that specializes in indirect instruments) and the capital market (that specializes in direct instruments).

In reality, it is hard to clarify the line that separates these two markets from each other because it usually blend into each other and one may have impact on the other as well. Fluctuations (in prices and interest rate) in the monetary market will trigger changes in the capital market. In contrast, changes (in stock index and prices) in the capital market may as well affect the monetary market.

(1) The monetary market

This is a place in which only short-term debt instruments (maturity of a year or less) are traded; and it is the source that provides short-term capital to the economy.

If its development is looked closely from the beginning of its introduction, through each of its developing phases, then the monetary market can be determined that it came into existence in the same time with the manufacturing industry. The capital market appeared only when the manufacturing industry has highly developed (market oriented economy). At this state, the monetary market has also achieved a high level of development and it could perform open market activities due to the participation of the Central Bank. Therefore, the existence of the capital market can only be considered as the supporting base to the monetary market and it relies onto the monetary market's activities.

Depend on each of participating instruments in the market, monetary market's activities can be done through interbank market, short-term securities market, and exchange market.

- The interbank market represents the lending relationship between credit institutions, and among the credit institutions and the Central Bank as well.
- The short-term securities market (including the open market) is a place for those short-term debt instruments such as Treasury bill, promissory note, commercial paper, certificate of deposit and other short-term valuable papers to be traded, transferred or exchanged.
- The foreign exchange market is a place where businesses involved in selling or buying, transfering, borrowing and lending of foreign currencies are taken place.

In Viet Nam, Article 9 (2) of the State Bank Law has defined: "The monetary market is the short-term capital market, it is the market for short-term debt instruments that include Treasury bill, State Bank bill, certificate of deposit and other short-term notes to be traded".

According to Article 70 of the Law of Credit Institutions, "Credit institutions are allowed to participate in the monetary market held by the State Bank, that includes Treasury bill auction market, domestic currency market, and foreign currency interbank market, and other markets for short-term instruments, which is specified by the State Bank". Thus, the monetary market can be described as consist of following markets: Treasury bill market; Domestic currency interbank market; Foreign currency interbank market; and other markets for short-term notes.

The monetary market performs two main functions:

- *First*, it provides financial instruments for the Central Bank to realize the monetary policy. The open market activities provided by the Central Bank include the services of selling and buying short-term debt instruments in the monetary market. The Central Bank may use this activity to control capital reserves of the commercial banks, the level of credit capability and money supply.
- *Second*, the monetary market allows funds to move from those who have surplus funds to those who have a shortage of funds, and from those who without productive investment opportunities to those who have such opportunities. By doing so, the monetary market contributes to higher production and efficiency in the overall economy. Generally, in a economy, the lenders-savers are individuals and households, and the most important borrowers-spenders are business firms and the government.

Because the monetary market is the wholesale trading market, then saving funds of those individuals and households are channeled to those who need through financial intermediaries; meanwhile, the Government and enterprises issue short-term securities with different conditions and terms and different maturity in order to satisfy the demand from investors.

The principal participating entities of the monetary market are commercial banks, non-banking financial institutions, enterprises and individuals. Out of these given parties, the Central Bank takes part in the market just for the goal of realizing its monetary policy, the tools it use can be known as interest, mandated reserve, open market activities. The commercial banks, non-banking financial institutions joint the market for their only purpose that is to maintain their payment ability, and to use surplus funds with the most efficient ways to bring back the most profitable return, or to obtain the most least cost for any necessary loans. The enterprises take part in the monetary market through their budget activities with the goal of keeping their fund stable for their production, thus the operation of the budget of any large enterprise may look similar to the commercial banks. That is that besides keeping their payment ability, it has to find the way to earn the highest profit for each of their single investment dollar. The participation of individuals into the monetary market depends on their attitude toward money saving or valuable papers, and depends on the motivation of keeping cash and keeping those papers. This participation is usually to do payments, to provide protection and prevention to unanticipated risks, and to earn profits from investment.

The credit market operates through the business of providing credits to enterprises. Its operation can also be seen in the activities of discounting, rediscounting of monetary market instruments, which aim to control the amount of short-term funds. The instruments that being used by the commercial banks and the Central Bank are:

- *Treasury bill*: this is a Government bond that was issued by the State Treasury with the maturity of one year or less. Even though the interest rate of the Treasury bill is normally lower than that of other debt instruments, it is widely used in the monetary market due to its safety and its high liquidity because it can be easily transferred in the secondary market. Therefore, when the commercial banks encounter difficulties in credit debt balance, they often invest in Treasury bill in order to circulate their frozen fund. And the Central Bank employed the open market activities including bills to manage the volume of money putting into the circulation, limit or even strengthen the credit market.
- *Commercial paper*: it is a note that is originated from the trading with payment in arrears or represents the ownership of a package of consigned goods. In other words, commercial papers are special notes, which the holders of these notes have a right to claim for payment at the maturity date. The commercial papers include:
  + Bill of exchange: this is a written note given by the seller to the buyer by which the seller instructs the buyer to pay a specified sum at maturity date to a payee (payee and the seller are

usually the same person).

+ Promissory note: this is a written promise given by the buyer to the seller committing the maker to pay the payee a specified amount of money at maturity date.

+ Warehouse Receipt: this is a document listing goods or commodities kept for safekeeping in a warehouse. This document is given by the warehouse's owner, committing that the owner of the warehouse will deliver the goods to the owner of the goods or to any other person specified by the goods owner with ensorsement on the receipt.

- *Negotiable certificates of deposits*: this is a kind of receipt given by the bank to the customer, which stated that the bank did maintain an amount of deposit owned by that individual, which is indicated on the receipt. The certificate have also stated that its holder will receive interest periodically and the whole principal when it come to the maturity date. The holder of this certificate cannot withdraw the money before the maturity date. However, this certificate can be converted into cash in the monetary markets. The United State in the 60's already had secondary monetary markets that provide services of selling and buying of those certificates before its maturity dates. Typically, face values of those certificates of deposit are very high, and they are usually issued in order to raise additional fund for the banks to satisfy the demand for loans of their clients and to deal with the situation of cash withdrawals. The buyers of these certificates can be the government agencies, large enterprises, charity organizations, insurance companies, pension funds, or foreign financial institutions...

- *Bankers Acceptance* (BA) is the valuable paper, which stated the order for unconditional payment of a specified amount, at a certain time for the owner of this paper. This kind of banker's acceptance is "approved" by the bank, it means that the payment is backed by the bank. The BA has the same value as any other type of papers that is backed by the bank. Once approved by the bank, then the BA becomes transferable instrument in the market.

(2) The foreign exchange market

The foreign exchange market is a part of the monetary market, it specifically provides services for foreign currency transactions such as selling and buying, lending and borrowing of foreign currencies. These services are aimed to meet demands from participating parties.

The foreign exchange market has established and developed as a need for other developments such as the developments of good trading, services, credit relationships, payment as well as other social and cultural relationships between countries.

The foreign exchange market is very necessary for individuals, enterprises, banks, government to do payment, to borrow or to lend in order to meet various demands of foreign currencies.

The most important foreign exchange markets currently include New York, London, Tokyo, Singapore and Frankfurt markets. The global net trade volume (that is estimated in one way—buying volume or selling volume) in 1999 is more than USD 1350 billion/per day.

The structure of foreign exchange market

All the businesses involved in trading, borrowing, lending of foreign currency are very different in their characteristics. They are carried out in complying with different regulations and trading techniques. That is why they are processed in separated markets. Particularly as follow:

- The Foreign Bank-Note Market
- The Spot Foreign Exchange Market
- The Forward Exchange Market
- The Currency Futures Market
- The Currency Swaps Market
- The Currency Options Market
- The Currency Deposit Market, that specializes in the services of borrowing, lending of foreign currency.

In those markets,

+ transactions in the foreign bank-note market, spot foreign exchange market, forward exchange market, and in the currency swaps market are executed through the over-the-counter market (the OTC market).
+ transactions in the currency options market may be executed through the OTC market; or in the Currency Exchange.

Besides, the spot foreign exchange market is considered as the primary market. Others like the forward exchange market, the currency futures market, the currency swaps market and the currency options market are derivatives market, they originated from the spot foreign exchange market.

Characters of the foreign exchange market

- *The Foreign Exchange Market has its international character*: the foreign exchange market of each and every country is increasingly showing their obvious international colour. This character can be seen through these signs:

+ The process of price listing in the market is internationalized: Since the speed of science and technology inventions is faster than ever, especially in the information technology industry, then communications between the foreign exchange markets of every country in the world happen in a extreme speed, constant, non-stop, more instantly and timely. These facts have not just created the positive confidence, but it even required the prices to be adjusted more frequent, instant and synchronous. This is the reason to explain why the process of listing (of prices, interest, rates) in the foreign exchange market being internationalized. The result is the introduction of international price level.

+ The foreign exchange market is very sensitive to the outer impacts. Fluctuations in economy, politics, militaries, and diplomatic ... in the world will possibly affect the prices in the foreign exchange market.

- *The Foreign Exchange Market is a non-stop process*

The time zones are different for each country in the world, thus in any time of the day, there are always an open foreign exchange market, a ready to open ones and also there are markets about to close its business for the day. The sequence of open and close of foreign exchange markets may create opportunities for any individual who conduct business on foreign exchange to carry out their plans in any moment during the day.

The functions of the foreign exchange market

- Basic function of the foreign exchange market is generated by the straightforward development from one of the bank's basic functions; it is to help their clients carrying out international commercial transactions. Besides, the foreign exchange market also has other functions, such as:
- Helping the fund transaction processes between countries more effective;
- With the existence of the foreign exchange market, external value of the currencies is determined in accordance with the market rules of supply and demand.
- Through the use of the foreign exchange market, we can assure the collected amount of export, the payment amount of import, the investments and loans denominated in foreign currencies. All can be done through the forward, options, or swaps transactions, etc..

Members participating in the foreign exchange market are normally regulated by each country (The Law of Foreign Exchange). However, the most popular members can be:

- The commercial banks that are allowed to do business of foreign exchange.
- The Central Bank is the organizer of the market. It also participates in the market as general

administration agency. It manages the market in order to stabilize prices, to achieve the goal of the currency policy through the act of selling and buying foreign currency, participates in the market in order to provide services for their clients (government agencies, international organizations).

- The brokers: they participate in the market as the middlemen, a bridge, and they provide opportunities for suppliers and consumers to meet each other. It is not an obligation for the presence of the brokers, however, with their participation, the business in the market can be done quicker and more effective.
- Moreover, depending on each country's foreign currency policy, the participation members can be expanded to enterprises (usually large enterprises which involve in import and export activities), they can participate in the market directly.

(3) The securities market

This is a place that provides long-term capital for the Government and enterprises through different financial instruments such as stocks, bonds, etc.. Compare to monetary market instruments, the financial instruments of the securities market are usually longer in their maturity (normally over one year), higher in their interest, but also have higher level of risk.

In the history of creation and development of the financial markets, the monetary market has been created first due to low demand of fund in the population and most people concentrated in short-term funds. Then along with economic development, the demand of long-term funds for investment has approached and giving chance to the birth of the securities market, which responded to these kind of demands.

The operation of the securities market can be seen in two different types of market, the primary market and the secondary market. The primary market is the issuing market of financial instruments for the purpose of raising fund. In other words, through the primary market, the Government and enterprises can issue securities such as shares and bonds in order to raise fund from institutions and individuals, who possess surplus funds, for their business and production. This process has increased the overall investment fund for the entire society. The secondary market is a place where issued financial instruments are traded. This process is simply to replace the ownership, it did not increase fund for the issuers. Securities tradings may take place at the Stock Exchange or in the OTC market.

The legal entities that participate in the securities markets include:

- The securities issuers: they are enterprises that issue shares to raise fund or issue bonds to make loans. There is a relationship created between companies and shareholders or between the companies and lenders (bondholders). Besides, the Government can also issue bonds in order to raise fund for the social and economic development programs, and to support their limited budget.
- The financial intermediaries: they are securities companies conducting the business of brokerage

(for commission), dealing on own accounts, underwriting, investment portfolio management, and securities investment advisory. They can be thought of the middlemen who close the gap and create chances for the buyers and sellers to conduct business with each other. They keep the market's operations working constantly, honestly, fairnessly and efficiently. In addition, there are other service institutions to support the market's operation, such as securities depository institutions, designated settlement and clearing banks, rating agencies, etc..

- Investors: they are domestic or foreign institutions and individuals joining in the securities business. Between the investors and the issuers, a relationship of creditor - debtor has taken shape. This relationship is possible to be seen through the voting right, the right to share dividends, to receive interest and other attached rights.

(4) The relationship between the markets

Based on the basic structure of each market in the whole financial markets, the monetary market (includes the credit market, exchange market) and the capital market (the securities market) have shaped up close relationships, influent and impact on each other. Historically, the monetary market was considered to be the earliest market with the function of raising savings and providing short-term funds for investments. The next were the process of international trades and the introduction of international payment between countries due to different currencies and these helped to create a market for foreign currency exchange (the foreign exchange market). The latest is the securities market. This market provides and allocates long-term fund in order to overcome the difficulties of the monetary market, where only short-term funds can be found, and accordingly has created a united entity for the financial market.

Through the above research and analysis of the financial markets, it can be seen that there is a close relationship between these markets. Firstly, both the monetary market (credit and foreign exchange markets) and the capital market are links in a whole monetary-financial system of the nation; and it is gradually internationalized. Therefore, any change of a economy that impacted on a market would easily spread to other markets in the whole system. For instance, a change in the interest rate will trigger reactions from both short-term fund market and capital market; or a change in exchange rate will affect to both short and long-term funds. This symptom can be seen through any monetary and financial crisis. On the other hand, following the development of the economy, the financial market is every day being improved with more sophisticated and more complicated transactions, this makes the traditional separated line between financial instruments or between these markets become relatively unclear. The financial instruments are frequently used in different markets, and exchanged to each other. New financial instruments are developed continuously in which there are many mixed financial instruments with characters that used to be existed separately and used to be specific characters of different instruments. Hence, different parts of the financial market are getting closer to each other than ever.

The internal relationship in the monetary markets (credit, interest, and foreign exchange markets)

There is a close relationship between the foreign exchange market and the monetary market that one always depends on the other; one can affect and control the other. Changes in the monetary market will trigger certain changes in the foreign exchange market. This relationship can be proved by the following discussions:

- In theory, if the interest on financial assets denominated in currency A (suppose that it is foreign currency) increases while the interest on financial assets denominated in currency B (suppose that it is domestic currency) is unchanged or decreasing, given the same maturity and level of risk, then the investors tend to withdraw their funds from the currency B financial assets and shift their investments to the financial assets denominated in currency A. This is because they envision the relative growth of profits of the currency A financial assets. Due to a mass withdrawal of funds, the B currency value is likely to go down and the A's value to go up. This explained why a change of the interest rate in the monetary market could cause a corresponding change of exchange rate in the foreign exchange market.
- In the same given example, if the Central Bank intervenes to maintain the fixed exchange rate associated with the B and A currency, they may have to sell their A foreign currency in order to buy B domestic currency. This causes their foreign reserve to decrease, the volume of money in the circulation decreases as well, and it leads to a raise of the interest rate (other conditions could remain unchanged). As obvious as it can be explained, changes in the foreign exchange market (here is the intervention of the Central Bank in the foreign exchange market) could certainly pull along changes in the monetary market.
- The difference between spot price and forward price is the most obvious evidence showing the organic relationship between these two markets. This difference reflects the interest spread between two currencies in the monetary market.

A currency swap is a transaction of buying and selling simultaneously one foreign currency, however, their values may vary day by day. Actually, this is an interest swap transaction but is priced and traded in the foreign exchange market.

The relationship between the monetary market and the securities market is represented through the instruments of interest rate and exchange rate, which in turn impact on the securities' prices. The movements in the securities market often link closely to the macro-economy. Among two kinds of the basic commodities traded in the securities markets (shares and bonds), the bonds are mostly controlled by the market's interest rate. This interest rate, however, is usually affected by the economic activities in general and interest policy of the Central Bank in particular. The stock prices in the securities market usually reflect the anticipation (or expectation) of the investors about the operation as well as financial status of the company such as incoming returns, requested interest of the investors, etc..

- Exchange rate: this is a factor that has great impacts on investment decisions in the securities markets. If the investors predict the future devaluation of the domestic currency, then they will not likely to invest in securities, or they may replace their securities by foreign currency assets because securities are another form of money. If the money is devalued then the value of securities is in the same situation. The investors are likely to shift their investments to other foreign markets if this is permitted. It is the same in case of the devaluation of the domestic currency that the public would certain prefer to switch to gold or foreign currency instead of saving domestic money. It is again proved that the impacts of exchange rate could drive investments from the securities markets to the exchange market or vice-versa.
- Market interest rate: It can be argued that inflation and interest are the two macro-factors that have influence on the prices in the securities markets. Interest is the factor that causes direct impacts on securities' prices by changing the yield requested by the investors when they determined to invest in those securities. If the market shows the sign that the Central Bank will change the discount rate and rediscount rate, there will be immediately a change to the money supply and credit provided by the commercial banks, as well as the prices of securities. However, the levels of impact on shares and bonds are different.

The interest impact on bond's price: It is clear that the value of a bond is the total future returns of the bond at the current time. The total future returns of the bond is equal to the specified interests and it's principal. When converting the future value to the present, we must use discount rate and investor requested yield of that bond, the higher the interest, the more the bond will be discounted, and the lower the bond's value will be. In contrast, the lower the interest, the less the bond will be discounted, and the higher the bond's value will be. Thus, if the Central Bank increases (decreases) the discount rate, then the price of bond in the market will be lowered (raised), and the bond investment demand will strongly increase.

The interest impact on stock's prices: The impact that the stock's prices encounter will not apparently similar to the bond's prices. It is because that the relationship between the interest and the stock's prices is indirect relationship, and it does not occur in one-way direction. The rule to determine the stock's prices is determined by converting future values of the stock to the present and is calculated in conformity with dividend discounted formula as follow:

$$P_0 = DIV1/(r-g)$$

In which: P_0 is the present stock price; DIV1 is the next year expected dividend; r is the interest; g is the growth rate of the company.

If g is unchanged, then future share earning may not as stable as bond's but depends on the net income of the company, while this net income may vary in corresponding with the interest, and this variation may be greater or less than change of the interest depending on each particular case. If the interest is up due to inflation then the prices of goods may rise to match with the increase of initial expenses, and consequently, the company's income may also rise. At this point, the stock's price may be kept stable because the discount rate increases, the income increases as well, and these two factors benefit each other and keeping the share's prices stable. If the interest is up, but the future income of the company does not grow due to the reason that the company is unable to raise their price instantly against inflation, then the stock's price will decrease like the bond's price. If the interest rises while the company's future gross income is down because of factors that make the interest going up, then this will generate negative impacts on the gross income of the company.

In contrast with all of the above situations, the interest going down will cause similar opposite consequences. This can be argued that the relationship between interest and stock's price is not type of direct relation, and it is not completely a one-way relation like those of interest and bond. The impact of interest's change on share's price may vary depending on the causes of the change and the level of influence of the change on the future earning of the shares. However, through several researchs, it seems likely that the relationship between interest and stock's price is often contrast to each other because in case of market's interest is to rise, driving down the share's price, then the investors tend to shift their investments from shares to bonds, making the share's price to go down and vice-versa.

2. The relationship between money supply, interest rate and exchange rate

The Central Bank may use variety of different instruments to maintain the VND value. And the most obvious sign of the intervention from the Central Bank is the change in the money supply, interest rate, and exchange rate. There is tight tie between these factors, one may affect each of the others, and they are shown by the monetary policy of the Central Bank in different period of time.

(1) Theory of the relationship between money supply, interest rate and exchange rate

Basically, all of three above factors are the consequences produced by different interventions. However, they all are instruments using by the monetary policy that were directly employed in cases, which required quick resolutions for the occurrence of economic unbalance symptoms. In reality, intermediate instruments are most used including discount rate, open market activities, and minimum mandated reserve.

Discount rate

The Central Bank adjusts the circulating money by changing the discount rate in order to change the ways using by most of commercial banks to attain credit from the Central Bank. Once the change goes into effect, the reactions of commercial banks may vary depending on:

- The level of dependability of commercial banks on the Central Bank for the credit.
- The competitive capability of commercial banks when competing for fund from other agencies, especially international organizations.
- The banks' ability to control interest rate on loans.
- Interest rate in the interbank market: If this interest rate is lower than the discount rate then the banks would not make loans through discount gate; the volume of loans made through discount gate would gradually decrease in par with the growth of the interbank market.

The move to raise the discount rate and accordingly limiting the circulating money may lead to a decrease of inflation rate and a rise of foreign capital flow (it is the benefit of payment balance of the economy), also a possible down in foreign exchange rate. A backward move otherwise will lead to negative consequenses in contrast. In fact, the given resolution may be more complicate when executing because a raise of interest rate on loans in one country may efficiently affect another country. If these countries are also raising their discount rate, then the flow of foreign capital avail to the economy not necessaryly increasing. To a certain extent, the flow of foreign capital will have a great influence on the inflation rate. If the Central Bank buys foreign currencies deposited in commercial banks, then though the discount rate is raised, it certainly does not drain out the banks' foreign currencies reserve; this only drives up the interest rate on foreign currencies. It is said that when the Central Bank adjusts the discount rate, this is similar to a signal that the Central Bank may want to change the circulating capital volume.

Open market activities

The Central Bank may adjust the circulating fund volume by selling (buying) most of Government securities (mainly short-term bond) from commercial banks. When it buys Government securities, the creditability of commercial banks will increase and vice-versa. In other words, the event of buying Government securities of the Central Bank will indicate that there is an increase of circulating fund volume, and consequently a down of interest rate. These activities will affect the payment balance depending on:

- The capability of foreign banks to reserve and to trade with securities denominated in domestic currencies.

- The capability of foreign banks to buy Government securities denominated in foreign currencies from the Central Bank (The Central Bank buys foreign currencies).

Through the open market activities, the Central Bank not only obliged to follow closely the goal of changing the volume of money in circulation, but also they may use this method to relatively stabilize the interest rate of Government securities. The volume of securities in circulation will decrease if Government securities are bought and if other conditions are not to change then the market value of securities may be able to raise; and the selling of securities may as well have the opposite consequences. The open market operation may also have another use, it recovers the shortage in State's budget: the Central Bank will reduce the volume of money in circulation if it sell Government securities, this money, however, get circulated again through expenditure of the State budget, then the interest rate may not rise as expected. This is a method that currently is employed, securities are issued to temporarily attract money in the circulation. This amount of money then is reinvested into those short-term and mid-term projects; at last the fund has been raised once again go back into the circulation.

Rediscount of Treasury bill

The commercial banks can buy back Treasury bill (Treasury bill rediscount) from the public, enterprises, etc.. Then the Central Bank may buy back these Treasury bills from commercial banks. Doing so, both the Central Bank and the commercial banks have generated more money for the circulation and thereby affect to the interest rate, which could lowers the interest rate.

The payment balance may encounter some impacts, which is produced by the rediscount of Treasury bill denominated in foreign currency, this Treasury bill being repurchased in foreign currency and the use of foreign currency, which is collected form abroad. This method indirectly affects to the reduce of the volume of money in the circulation. However, in case that the Central Bank just buys back a moderate amount of Treasury bill (such as Treasury note or commercial bill) or limits the use of the profit earned from discount of the commercial banks, then this method can be considered as direct one.

Mortgage credit

The Central Bank uses this method to provide credit to commercial banks in order to raise the volume of money in the circulation. The payment balance is affected by the practice of providing mortgage credit in form of foreign currency and by the use of this type of credit in overseas. The mortgage credit is quite similar to the discount of Treasury bill. The considering differences are:

- The Central Bank may ask for the Treasury bill to be paid off at maturity date when the

Treasury bill being discounted. In the mortgage credit, securities (usually mid-term bonds) will be paid to commercial banks on the maturity date.

- The practice of using rediscount to raise the volume of money in the circulation can be limited by the maturity of Treasury bill. In the mortgage credit, the maturity date is not necessary to be in par with the validation of mortgaged securities.

Like the rediscount of Treasury bill, this method may not be used directly to reduce the volume of money in the circulation. In some cases (such as mortgage of some kind of securities, limiting the use of mortgage), this method is more direct.

Minimum level of mandated reserve

In general, the madated reserve is market interest rate function, the higher is the interest rate, the higher opportunity cost for non-interest deposit, and the smaller reserve to be. In a constant environment, raising the level of mandated reserve will reduce the credit capability of commercial banks and vice-versa. The mandated reserve may affect the payment balance if including deposit denominated in foreign currency. At this point, raising the level of foreign currency reserve may increase the foreign capital, reducing foreign currency reserve can lead to the loss of foreign capital. Suppose that the creditability of commercial banks is not limited then the mandated reserve will have multi-face impact on deposits. This impact may reduce the efficiency of mandated reserve. However, the mandated reserve is still considered as a great method because it directly concerns about the creditability of commercial banks, then the banks are persistently support this method.

If the level of mandated reserve is set equally for all the banks or slightly different depending on each group of banks, then this is one of the indirect management instruments of the Central Bank. If this level is separated then it will be considere as direct instrument.

The mandated reserve provides the Central Bank an instrument needed in some cases. Among other roles may involve, the change of interest will occur when the minimum level of mandated reserve is changed. Raising the level of mandated reserve will lead to a rise of interest rate (mostly in the monetary market), the reason is that commercial banks will try to recover their reserve's shortage and they incidently make credit more expensive. In fact, the change of the level of mandated reserve is not relate to the interest rate, but more concerns about the legal level of reserve of commercial banks; indirectly using the banks' reserve to change the volume of money in circulation and credit - but this method has again affected the interest rate.

Among the indirect effects of the open market activities or the mandated reserve, the Central Bank can also affect the volume of circulating money directly by setting regulations on liquidity. That is to buid a mechanism and a relationship between capital and debt (based on the balance of payments and receipts) of those commercial banks. These methods are more apparently directive if they are more specific. In most of market-driven economies, the regulation on liquidity carries two similar characters:

- They relate to assets (capital) and debt, their system including foreign currency.
- They are basic requirements for getting banking business lisence, and this business will be encouraged if those requiremets are seriously carried out.

If the amount of money deposit is higher compare to credit (suppose that there are no changes to other conditions), then the volume of money in circulation will decrease.

The impact on payment balance is clear only in case that those regulations on liquidity affect the amount of money deposit and foreign currency creditability - the commercial banks respose to the decision of the Central Bank to raise the level of mandated reserve through the act of raising the interest rate on money deposit denominated in foreign currency (no impact on the payment balance).

The regulations on liquidity are used in all market-driven economies mostly because it protects the liquidity of commercial banks. These regulations can only be changed in special events, which aim to raise or to lower the amount of money in the circulation.

Credit limit

The method of setting maximum credit limit may have great influence on the amount of money in the circulation. There are two basic ways to set up the limit:

- Setting a relative limit showing a maximum level of credit that the Central Bank may be ready to provide to the commercial banks. This credit line is possible to be used in rediscounting bills and in mortgaging.
- Setting an absolute limit showing a maximum level of credit that the commercial banks can avail for loans.

Credit limit, especially the absolute limit, is very efficient for use but only in special cases because it can directly intervene into the commercial banks' activities, causing a flow of strong protests from those commercial banks. Therefore, credit limit should be used very cautiously and different fof different commercial banks, until then this method may prove itself as an effective tool.

Exchange rate intervention

The goal of the intervention is to affect the change of exchange rate in order to alter the amount of