

Chapter 13

CAPITAL FLOWS AND THEIR IMPLICATIONS FOR CENTRAL BANK POLICIES IN VIETNAM

by
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1. General Framework and Major Capital Flows Management Policies

1.1 Current Account and Trade Liberalisation.

In December 30, 2005, Vietnam was recognised by the IMF as completing its member obligation to fully liberalise its current account in compliance with the Fund's Article VIII (compared with 1968 for Malaysia, 1990 for Thailand and 1996 for Mongolia). Payments and transfers for current account transactions can now be freely made through the commercial banks. The requirement for the economic institutions to surrender their foreign exchange was gradually reduced from 80% (1998) of their foreign currency revenues to 50% (1999), 40% (2001), 30% (2002), and finally abolished in April 2003.

Besides, the Vietnamese Government is continually adjusting its policies to encourage remittance from overseas. Fee on remittance receipt was lifted in 1982 and income tax on remittance receipt was exempted in 1999. The local beneficiaries are allowed to withdraw or hold remittance in foreign currencies since 1999. At the same time, many institutions were licensed to carry out remittance transfer service. As a result, remittances into Vietnam increased dramatically from US\$0.95 billion (1998), \$2.6 billion (2003), over \$3 billion (2004), \$4.1 billion (2005), \$4.1 billion (2006), and to \$6.4 billion in 2007.

With its open and liberalised trade policies, Vietnam is well integrated into the world economy. As a member of the AFTA, APEC and, most recently, the WTO, together with the associated advantages, Vietnam has emerged as one of the most attractive destinations for global investors, especially in the period of 2006-2007.

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Being an official member of the WTO, however, also means that Vietnam is obliged to cut tariffs, remove domestic protection and further open the door to fierce competition, allowing foreign investors entry into its commercial and financial markets. This has brought about many challenges as well as opportunities to Vietnam's economy and its policy development and management.

1.2 Capital Account Liberalisation

Together with a fully liberalised current account, Vietnam has removed many restrictions on its capital account, taking significant steps towards a fully liberalised capital account. Since its issuance of the first Law on Foreign Investment in 1988, Vietnam has continually amended as well as issued many new and relevant laws and legal provisions to create a transparent and favorable legal framework to encourage foreign investment, especially FDI into the country.

1.2.1 Foreign Direct Investment (FDI) Policy

In 2001, the State Bank of Vietnam (SBV), the central bank, removed the requirement of foreign currency self-balancing applied to FDI enterprises. FDI enterprises can buy foreign currencies from commercial banks for their legal needs. The government even guaranteed to sell foreign currencies to some important FDI projects. The door to FDI inflows has been cast open wider and wider with each passing year. The compulsory requirement on export ratio or limitation on the ratio of capital contribution made by technology transfer, and employment in FDI projects, were removed. The withholding tax on profit remittance of FDI projects was lowered and subsequently abolished. The limitation of 30% for foreign ownership in FDI enterprises was abolished, with some exceptions. As a result, Vietnam has witnessed a sharp and continuous increase of FDI inflows since 1988.

1.2.2 Portfolio Investment: Foreign Indirect Investment (FII) Policy

Vietnam's stock market initially came into play in July 2000 with few listed companies. In order to encourage foreign portfolio investment (FII) as an important drive towards domestic capital market growth, the Vietnamese Government issued a regulation in 2003 on capital contribution and share holding by foreign investors in Vietnamese enterprises. Under this regulation, foreign investors can contribute capital or buy shares up to a maximum equivalent of 30% of Vietnamese enterprises' legal capital. Individual investors are tax-exempted for their income from capital contribution or share purchase in Vietnamese enterprises.

For further FII encouragement, on 12 December 2004, the SBV removed the requirement of FII to remain at least one year in the country before it can be repatriated. Foreign investors are allowed to buy foreign currencies to transfer their invested capital and profit out of the country freely at any time after fulfillment of tax and other obligations. Therefore, there is currently no regulation restricting the withdrawal of foreign investment out of the country. However, foreign capital on arrival is required to be converted into the local currency and held in a specialised account with a commercial bank to realise the investment in Vietnam.

The permitted room for foreign participation was increased from 30% in 2003 for both listed and unlisted companies to 49% in 2005 for listed companies, except banks.

Foreign holdings of valuable papers issued by financial institutions are limited up to 50% while there is no restriction on foreign holdings of listed bonds in Vietnamese stock market.

1.2.3 Outward Investment Policy

Besides stimulative policies to attract foreign investment, the government also gradually liberalised its external investment policy. Before 2005, domestic enterprises could use only foreign currencies from their current account revenue for investment abroad. Since 2005, they can also use foreign currencies bought or borrowed from eligible banks for overseas investment.

1.2.4 External Borrowing Policy

Vietnam also adopted relatively open external borrowing policies. Enterprises are allowed to borrow overseas to fund their permitted, registered business activities and are self-responsible for repayment as contracted. Loan registration after contracting and periodical reports of loan disbursement to SBV are required only for medium-term and long-term loans. Disbursement of such loans can only be made after duly complying with the requirement of loan registration with the SBV. External borrowing by public sector should meet SBV's relevant requirements and be subject to the nation's annual total commercial credit ceiling. Individuals can borrow overseas as long as they meet the conditions set by the SBV.

1.2.5 Overseas Lending Policy

In terms of external lending policy, the financial institutions can extend financial and commercial credit overseas. Registration and periodical reporting to SBV are required after entering the contract. Economic institutions can lend overseas only with approval of the Prime Minister and registration with SBV. Individuals are not permitted to lend overseas.

1.3 Other Relevant Policies

1.3.1 Monetary and Fiscal Policies

During a long period from 1999-2006, Vietnam adopted accommodative monetary and fiscal policies in order to boost local investment and consumption for economic growth and cope with the potential threat of deflation under the impact of the Asian financial crisis. The SBV gradually liberalised its interest rate policy, shifting from direct to indirect management. Deposit and lending interest rates of both local and foreign currencies were fully liberalised in June 2002. At the same time, the SBV continues to announce the SBV's directive interest rate (so-called base rate) as a reference for the market. However, it is stipulated under the Civil Law of Vietnam that the local currency interest rates should not exceed 150% of the SBV's base rate with a view to avoiding extremely high rate loans. The amendment of the Civil Law regarding this issue is proposed.

1.3.2 Exchange Rate Management Policy

In 1991, the SBV reformed its exchange rate management mechanism from multi-exchange rate system into a unified one. The SBV announced the daily official rate of USD/VND as the central rate for commercial banks to determine their trading exchange rates within a certain band set, and adjusted when necessary by the SBV's Governor for each particular period. Vietnam's exchange rate regime at that time was classified by the IMF as conventional peg.

In February 1999, the SBV abolished the announcement of official rate, shifting into calculating and announcing the daily inter-bank weighted average exchange rate as the reference for commercial banks' trading exchange rate determination within a certain band. This was a significant change in Vietnam's exchange rate policy as it moved from subjective management mechanism into market-oriented one. As a result, the exchange rate mechanism of Vietnam was classified as managed floating by the IMF in 1999.

Table 1
Exchange Rate Developments of VND 1997-2007

USD/VND / Year	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Inter-bank weighted average rate (end year)	11175	12985	14210	14501	15070	15368	15608	15739	15875	16091	16114
Yearly change (%)	1.1	16.2	9.4	2.0	3.9	2.0	1.6	0.8	0.9	1.4	0.1
Inter-bank weighted aver. rate (annum aver.)	11127	12203	13935	14155	14786	15243	15475	15704	15816	15963	16126
Yearly change (%)	0.9	9.7	14.2	1.6	4.5	3.1	1.5	1.5	0.7	0.9	1.0
Vietcombank's selling rate (end year)	12293	13894	14030	14515	15085	15406	15647	15778	15915	16055	16030
Yearly change (%)	10.2	13.0	1.0	3.5	3.9	2.1	1.6	0.8	0.9	0.9	-0.2
Vietcombank selling rate (annual aver.)	11689	13263	13945	14169	14801	15270	15513	15743	15856	15995	16086
Yearly change (%)	5.9	13.5	5.1	1.6	4.5	3.2	1.6	1.5	0.7	0.9	0.6

In parallel with the SBV's frequent intervention in the domestic foreign exchange market to prevent it from excessive or unreasonable fluctuations, the allowed trading band of commercial banks was gradually widened from $\pm 0,1\%$ (2/1999) to $\pm 0,25\%$ (7/2002), $\pm 0,5\%$ (12/2006) ; $\pm 0,75\%$ (12/2007); $\pm 1\%$ (3/2008) and $\pm 2\%$ (6/2008), $\pm 3\%$ (12/2008).

Vietnam's capital account has been liberalised and quite open. Apart from some regulations limiting the maximum level of participation that can be made by foreign investors in Vietnam's companies or in some special areas, Vietnam's Government does not impose any restrictions on capital inflows and withdrawals. On the one hand, this liberal policy framework has created strong incentives for the stimulation of foreign investment, resulting in great opportunities for economic development. On the other hand, it has led to increasing dramatic fluctuations of capital flows into and out from the country, creating series of unpredictable mini-shocks in foreign exchange market. Vietnam's macroeconomic policy framework is complicated by the dilemma of the "Impossible Trinity."

By the Theory of the Impossible Trinity, a country cannot simultaneously achieve the three main goals of macroeconomic policies: flexible capital flows, stable exchange rate, and monetary autonomy. As a result, every country that liberalises its capital account should adopt a flexible exchange rate policy if it aims to maintain monetary autonomy. However, a relatively stable exchange

rate is viewed by the Vietnamese Government as a key factor to the country's economic development. Therefore, increasing the flexibility of capital flows into the country posed great challenges to Vietnam in its efforts to maintain its exchange rate management policy.

2. Trend of Capital Flows in Vietnam since 1985

Along with its course of economic reforms and global integration, Vietnam attracted an increasingly significant amount of foreign investment in contributing to its economic development. Since 1995 until now, the surplus in its capital account has been rising (except 2000).

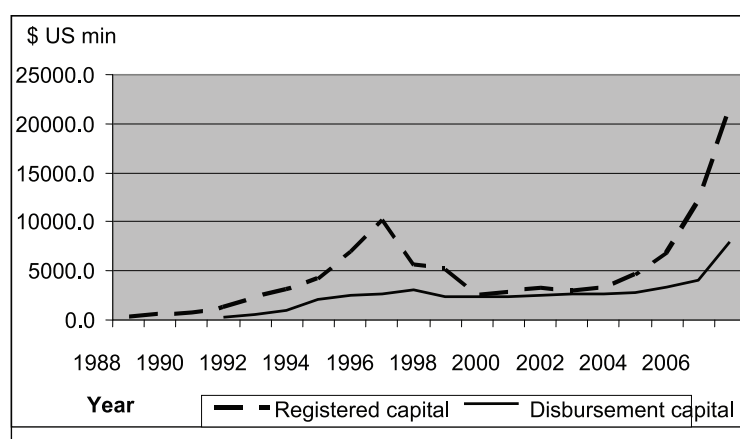
2.1 Inflows

2.1.1 FDI Inflows

FDI contributed the highest proportion in Vietnam's capital inflows. Since 1998 with the enforcement of its Law on Foreign Investment up to December 2007, Vietnam attracted \$99.6 billion of registered FDI capital, of which US\$45.5 billion had been realised.

As can be seen from Figure 1 below, FDI inflows in Vietnam recorded the first peak in 1996 and then cut into half in 1997-1998 under the impact of the Asian financial crisis. FDI inflows in Vietnam recovered in 2000 and have since increased dramatically from Vietnam's accession to WTO.

Figure 1
FDI into Vietnam 1988-2007

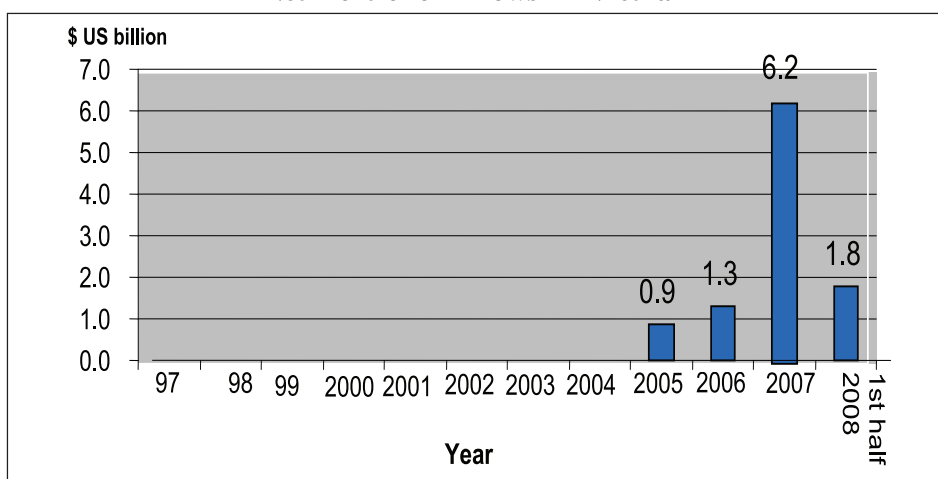


The registered amount of FDI recorded at US\$21.3 billion in 2007, exceeding the total registered amount of US\$20.8 billion for the whole period of 2001-2005. It continued to reach US\$64 billion in 2008, equal to three times the registered amount of the previous year. The disbursement was US\$11.5 billion in 2008, increasing by 43.2% against 2007.

2.1.2 FII Inflows

Until 2004, foreign portfolio capital (FII) inflows into Vietnam were insignificant given its infant stock market and poorly developed money market. However, Vietnam witnessed an amazing surge of foreign portfolio inflows, which rose from nearly zero in 2004 to the record of US\$6.2 billion in 2007 amidst the boom of Vietnam's stock market and the perceived attractiveness of Vietnamese economy after its WTO entry.

Figure 2
Net Portfolio Inflows in Vietnam

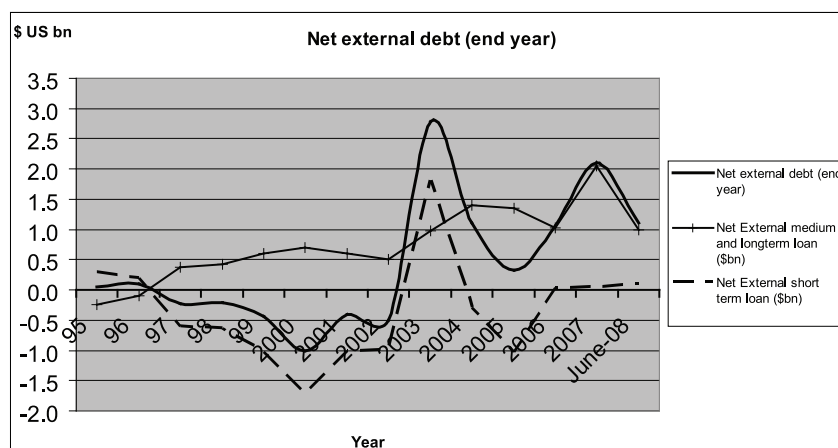


Besides its positive effects on the local capital market development, the sudden surge of foreign portfolio inflows had posed many challenges to Vietnam's nascent financial and money market. However, there has been a declining trend in net portfolio inflows into Vietnam since the second quarter of 2008 as the inflows dropped and the withdrawal amount plummeted. The net portfolio inflows to Vietnam were just US\$1.8 billion for the first half of 2008, just equal to 27.7% of the total FII inflows of Vietnam in the last year.

2.1.3 External Debt

Vietnam's net external debt only made a positive contribution to its capital account since 2003. By the end of 2007, the total outstanding external debt of the country was US\$23.2 billion, of which, short-term debt incurred by private sector was only US\$0.2 billion, accounting for 0.9% of total external debt. Approximately 97-98% of Vietnam's external debt consists of medium and long-term loans under the form of ODA or commercial loans incurred by enterprises for machines and equipment purchase. Its total short-term external debt was equal to 1/95 of its foreign exchange reserve by the end of 2007, far below the alarming limit of 1/2 specified by the IMF. The ratio of Vietnam's external debt/exports has gradually decreased from 82% in 1997 to 37.8% in 2007, far below the maximum permitted level of 200% specified by the IMF. As a result, there is not much risk of sudden capital flight for its external debt.

Figure 3
Vietnam's Net External Debt (End Year)



According to the IMF and WB ratings, Vietnam is not included in the list of High Indebted Poor Countries (HIPC). All the external debt sustainability indicators of Vietnam have always been well below the IMF or WB's applicable debt thresholds, reflecting Vietnam's mostly concessional and long-term structure of external debt, as well as its dynamic export sector. The annual debt service of Vietnam has been always in the range of 7.3-13.9% of its exports of goods and services, which is lower than the highest border of the permitted safety range.

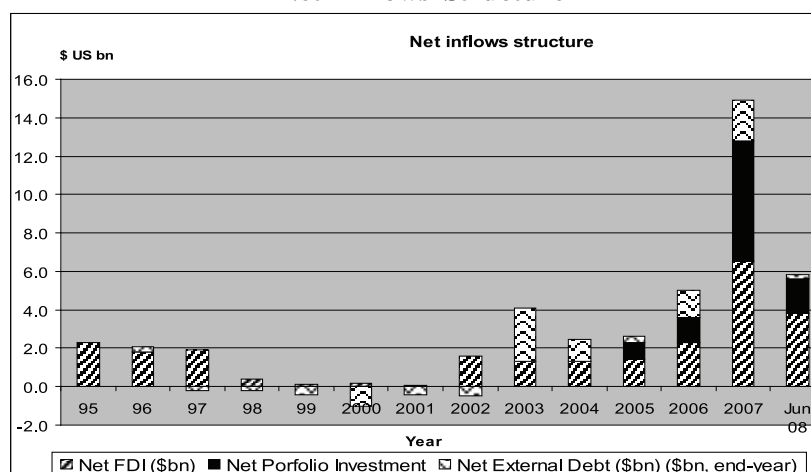
Table 2
Vietnam's External Debt Sustainability Indicators

Indicators (%)	97	98	99	2000	2001	2002	2003	2004	2005	2006	2007	Applicable Safety Threshold
PV of External Debt /GDP	37.5	37.9	34.2	39.3	40.3	37.6	34.2	33.9	32.0	30.2	29.0	< 45%
<i>PV of External Debt/ Exports</i>	82.0	82.0	70.0	70.0	70.9	63.0	57.0	45.5	42.0	39.0	37.8	< 200%
<i>Debt Service/Exports</i>	12.8	13.9	12.8	10.5	10.6	7.5	7.5	7.3			3.94	< 25%

2.1.4 Structure of Net Capital Inflows

As far as the capital structure is concerned, FDI has always contributed the biggest proportion in Vietnam's total net inflows (except the year 2003). This is a good reflection of a healthy capital structure, facilitating sustainable development of Vietnam's economy in the long term. However, the sudden increase of portfolio investment into Vietnam since 2005 is noteworthy and necessitated an appropriate response as it raised the proportion of short-term and volatile capital in Vietnam's capital structure.

Figure 4
Net Inflows Structure



2.2 Capital Outflows

Because of the limited financial capability of Vietnamese enterprises and great demand of capital for domestic economic development, the outward flow of investment and lending during the past years was insubstantial. There were just 280 FDI projects abroad with a registered capital of US\$1.26 billion made by Vietnam during the period of 1989- 2007, of which only approximately 17% has been realised. No portfolio investment and almost no overseas lending was registered during the same period.

A significant and most volatile part of Vietnam's capital outflows is its banking system's investments abroad in the placement of deposits with foreign banks. The volume of this part of capital outflows is primarily subject to the interest rate developments in the world market. In the years 2000 and 2001 when the world's interest rates went up, with the FED fund rate climbing to the highest level over 40 years, Vietnam witnessed huge capital outflows (US\$2.1bn in 2000 and US\$1.2 billion in 2001), being the domestic banks' overseas investments from their huge amount of domestic deposits in foreign currencies. This was one of the main reasons for Vietnam's capital account deficit in the year 2000.

3. Determinants of Capital Flows in Vietnam

3.1 Possible Causes behind Surge in Capital Inflows into Vietnam

3.1.1 External Factors

The sharp depreciation of the US dollar in the international markets since 2002, together with the economic recession starting in the US since 2001, induced global investors to seek for investment opportunities outside the US and in US currency-denominated assets. The economic conditions in many other regions were also not good for new and high-return-oriented investors. Many big countries started to cut down interest rates to cope with the threat of economic recession and weakening financial systems, therefore undermining the attractiveness of their local currency-denominated assets.

On the other hand, it comes out obviously that, the more integrated and globalised the world's market, the more diversified the outreach of global portfolio investors looking for investment. In such a context, Asia has emerged as the most attractive destination for global investors thanks to its continual high economic growth, cheap labor, and large emerging market, which promises high returns from high-yielding assets.

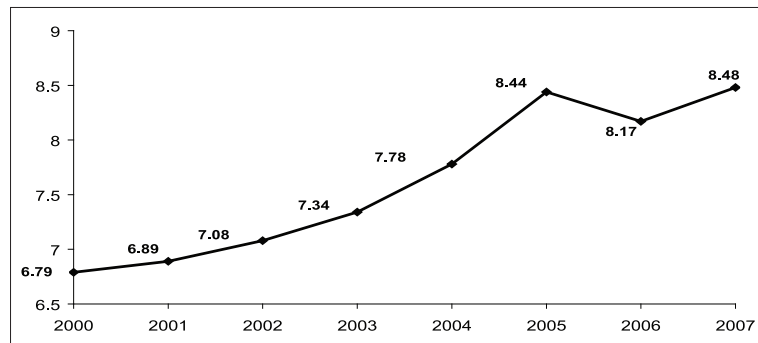
3.1.2 Internal Factors

Vietnam's outstanding economic achievement and its advantages as a newly emerging market are the main driving forces behind the strong capital inflows into the country in recent years, especially in the context of the current global economic recession.

(i) Fast Growing Economy

Over the last 13 years from 1995-2007, Vietnam achieved great success in economic development, attaining on average a growth rate of 7.58% annually, much higher than the average rate of 6.5% of the whole region. With GDP growth rate of 8.5%, Vietnam was the second fastest growing economy in Asia after China in 2007. Characterised by a stable political environment, Vietnam is viewed to have great potential for strong economic growth, thanks to its comparative advantages, such as cheap labor force, newly established and cheap stock and real estate market, newly established financial and foreign exchange markets.

Figure 5
Vietnam's Economic Growth Rate (2000-2007)



(ii) High Demand

As a developing country with a widening savings-investment gap, there is high demand in Vietnam for foreign capital for economic development. On the other hand, as a newly emerging market with numerous under-capacity industries and huge demand for equitisation, Vietnam offers tremendous opportunities for foreign investment.

(iii) Easy Access

With its fully liberalised current account, open-trade policy and quite liberalised capital account accompanied by foreign investment incentives and stable exchange rate regime, Vietnam offers to be an attractive and easily accessible destination for foreign investments, especially after its WTO's membership.

(iv) Great Interest Rate Differential

The expectation of stable exchange rates of VND makes the great interest rate differential between local and international monetary markets (8% in 2007 and 12% in early 2008) even more attractive for foreign portfolio investment.

Table 3
Vietnam's Selected Macroeconomic Indicators (1995-2008)

Indicators	95	96	97	98	99	2000	2001	2002	2003	2004	2005	2006	2007	6/2008
Real GDP Growth rate (%)	9.5	9.3	8.2	5.8	4.8	6.8	6.9	7.1	7.3	7.8	8.4	8.2	8.5	6.5
CPI inflation (% change, over Dec. Dec.)	16.9	5.6	3.6	8.9	0.1	-0.6	0.7	4.0	3.0	9.5	8.4	6.6	12.6	18.4
Nominal 3 month deposit rate (%/annum end of year)	-	-	8.1	9.7	4.0	4.3	5.4	6.7	6.1	6.7	7.8	7.9	12.0	17.5
Real interest rate (based on CPI end year)	-	-	4.5	0.8	3.9	4.9	4.7	2.7	3.1	-2.8	-0.6	1.3	-0.6	-0.9

3.2 Possible Causes behind a Decline in Capital Inflows since Quarter II of 2008

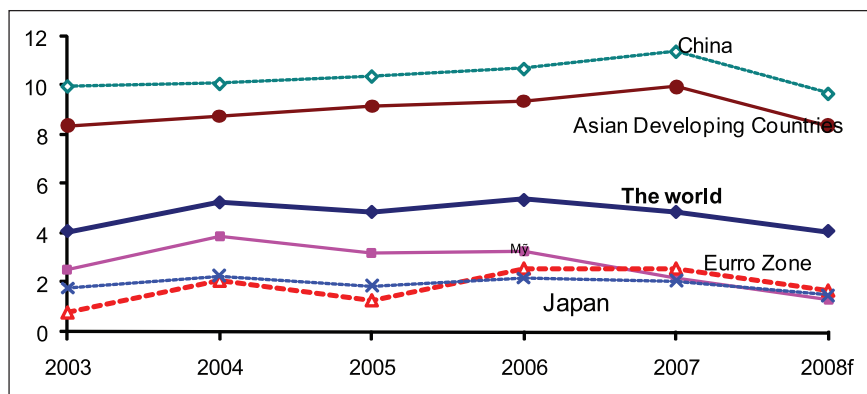
Since the second quarter of 2008, Vietnam has witnessed a declining trend of net capital inflows as less portfolio capital inflows are pouring into the economy and more portfolio capital withdrawn out of the country both due to external and internal reasons. However, committed FDI continued to soar and recorded US\$31.6 billion in the first half of the year, equal to 3.7 times the total of 2007's committed FDI, which exceeded the total registered amount of FDI for the whole period of 2001-2005.

3.2.1 External Factors

Erupting in the United States in August 2007, the sub-prime credit crisis has spread quickly worldwide and swelled out into the largest-ever global financial crisis since the Great Depression of 1929-1933. The crisis triggered huge losses and massive collapse of major global financial and banking institutions, badly shaking all the major financial markets throughout the world. It also led to a credit crunch and liquidity tightening in the world inter-bank market, inducing capital withdrawals of foreign institutional and individual investors out of developing countries, including Vietnam, due to the need of liquidity support for their parent companies and their increasing risk adverse appetite.

The worsening global economic recession is a main cause contributing to a decline in capital inflows into Vietnam in recent months.

Figure 6
World's Economic Growth (2003-2008)



3.2.2 Internal Factors

Performing on the back of the external economic situation and sharp price movements in the world market, the Vietnamese economy experienced overheated growth during the past one year and seemingly went into an adjustment period accompanied by some macroeconomic uncertainties.

(i) Double-digit Inflation and Economic Slowdown

After many good years of control over inflation, Vietnam's CPI index climbed to double-digit level at 12.6% in 2007 and continued to mount up to 21.87% just in first nine months of 2008, nearly doubling the total CPI index increase of the

previous year. The monthly increase of CPI index recorded the highest level in the past 16 years at 5.3%/month in May 2008. High inflation turned the domestic real interest rate into negative, triggering a strong reduction in consumption spending and a slowdown of the whole economy. Vietnam's economic growth rate decreased from 8.4% in 2007 to 6.23% in 2008.

Figure 7
Vietnam's Monthly CPI Index in 2007

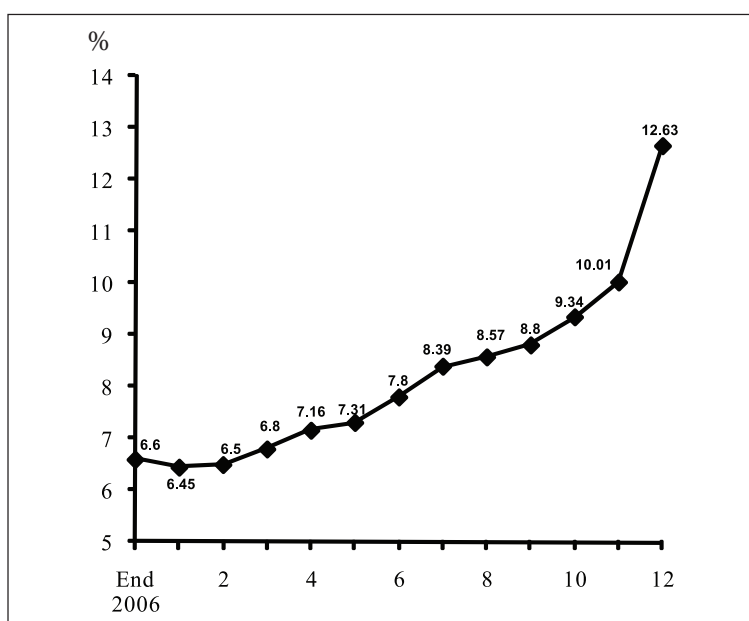
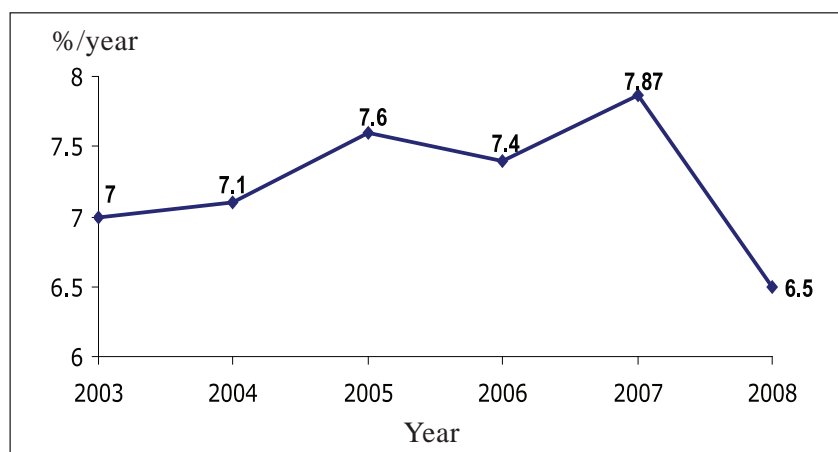


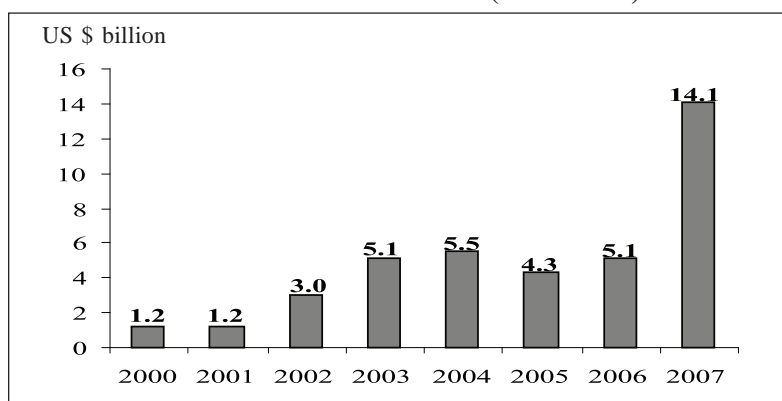
Figure 8
Vietnam's First 6-month Economic Growth (2003-2008)



(ii) Huge Trade Deficit

On the one hand, the growth of foreign trade activities as a result of open trade policy and current account liberalisation, created various export opportunities for Vietnamese enterprises. On the other hand, it contributed to push up the country imports. Import tariff reduction under commitments to WTO also encouraged the country's imports to meet its accelerating aggregate demand. Additionally, the dramatic increase of FDI inflows themselves contributed a main drive for the country's increasing imports of machines, equipment and input materials. Consequently, Vietnam's trade deficit has quickly widened from US\$5.1 billion in 2006 to \$14.1 billion in 2007 (equivalent to -11.9% of GDP) and continued escalating to reach the record level of US\$14.8 billion just in the first half of 2008.

Figure 9
Vietnam's Trade Deficit (2000-2007)



(iii) Widening Budget Deficit

As a result of an expanding fiscal policy implemented by the Vietnamese Government since 1999 to facilitate economic growth and living quality improvement, the state budget deficit widened to -5.9 % of GDP in 2007.

(iv) Strong Adjustment in Stock and Real Estate Markets

After the boom in late 2007 and early 2008, both the real estate market and stock market experienced a strong adjustment reflected in a freezing real estate market and a drop of almost 70% of VN Index just in six months.

(v) *Credit Rating Downgrade*

Given some signs of domestic macroeconomic imbalances and concern among foreign investors about the resilience of the Vietnamese economy and the banking system to the worsening global financial market, Moody and Standard & Poors lowered Vietnam's credit rating from "stable" or "positive" to "negative". However, this agency still maintains a positive assessment with regard to the long-term outlook and prospects of Vietnam's economic growth.

Table 4
Credit Rating Outlook of some Asian Countries Rated by S&P
(May 2008)

	Credit Rating on Internal Debt	Credit Rating on External Debt
Vietnam	BB+	BB
Indonesia	BB+	BB-
China	A	A
Thailand	A	BBB+
Malaysia	A+	A-

Vietnam's huge trade deficit together with its widening budget deficit raised concern among investors about the sustainability of Vietnam's balance of payment, especially in the context of flexible capital flows and deepening global financial crisis. In addition, the on-going increase of domestic inflation rates and signs of liquidity tightening in the banking system added more anxiety to foreign and even local investors regarding the country's economic prospects and the potential devaluation of the Vietnamese Dong. This badly affected the confidence of foreign investors over Vietnam's short-term economic prospects and triggered a partial withdrawal of foreign short-term investment out of the country in the middle of 2008.

4. Implications of Capital Flows for Central Banks Policies and Its Response

Alongside great opportunities for economic growth and market development that can be reaped from capital inflows, the increasing volatility of capital flows in and out of the country pose tough challenges to the SBV. The greatest

challenge may be the problem of the impossible trinity, which is manifested in the tremendous difficulties of SBV in maintaining a stable VND exchange rate and independent monetary policies under the impact of strong fluctuations in capital flows in recent times.

4.1. Implications of Rocketing Capital Inflows for Central Bank Policies and Its Response

4.1.1 Exchange Rate Management Policies

(i) Implications

A surge in capital inflows into Vietnam, especially since late 2006, significantly changed the balance between demand and supply in the local foreign exchange market. In the past, the demand for foreign currencies was always greater than the supply, the VND was hence always under the pressure of depreciation. Dramatic increase of capital inflows, especially portfolio capital pushed up the supply of foreign currencies in domestic foreign exchange market to outweigh the market demand, thus creating the first-ever upward pressure on VND. Instead of always quoting their trading exchange rates at the ceiling of the controlling band as in the past, all banks then traded at floor rates. The black market witnessed for the first time in its history the drop of US dollar/VND exchange rate to a level far below trading rates in the official markets.

The situation became more serious in the first quarter of 2008 when the supply of foreign currencies from capital inflows continued to increase to over-exceed the market demand, putting the local currency under strong pressure of appreciation. The wide expectation of further VND appreciation due to the forecast of continuously increasing capital flows into the economy induced market participants to flee or stay away from US dollar or US dollar-denominated assets. Local people and companies rushed to convert their foreign currency holdings into Vietnamese dong to avoid further depreciation of US dollar and to make benefit from high VND interest rates. Banks did not want to be long in foreign currencies as the market demand for foreign currencies declined sharply while the exchange rate of US dollar/VND dropped day by day both in the official and black markets. At the same time, the local inter-bank market started to face tightening liquidity of VND. As a result, the SBV was facing tremendous challenge in maintaining its primary objective to keep exchange rate stable and competitive for export promotion.

(ii) Central Bank's Response

a. Exchange Rate Adjustment

Instead of trying to keep the reference rate under as little change as in the past, the SBV proactively adjusted the reference exchange rates towards gradual appreciation of VND to keep pace with market movements. The exchange rate trading band was widened two times from $\pm 0.25\%$ applied since 2002 to $\pm 0,5\%$ and then $\pm 0,75$ in 2007 and another time to $\pm 1\%$ on March 2008 (see Table 8). Consequently, the VND appreciated 1.12% in the official market and 1.4% in the black market in the first quarter of 2008 for the first time ever.

b. Foreign Exchange Intervention and Sterilisation

In parallel with the reference rate adjustment, the SBV also intervened to stabilise the domestic foreign exchange market by purchasing foreign currencies from commercial banks to prevent local currency from too much appreciation. By doing so, the SBV, on the one hand, helped reduce foreign currency over-supply, easing upward pressure on VND. On the other hand, it consolidated its foreign exchange reserve, which climbed from US\$10.4 billion from late 2006 to US\$19.6 billion by the end of 2007.

However, this inevitably led to the increase of local currency in circulation, pushing up inflation, thus badly affecting the VND Real Effective Exchange Rate and the economy's external competitiveness, creating difficulties in monetary policy formulation. Great efforts were made by the SBV to neutralise these adverse effects through intensive open market operations and other creative measures in money market (see in 4.1.2).

c. Other Relevant Policies

In order to help ease upward pressure on VND due to over-supply of foreign currencies, the SBV encouraged prepayment of external debt by enterprises and banks, and modified its regulations to allow importers to get loans in foreign currencies.

4.1.2 Monetary Policies

(i) Implications

a. Inflation Increase

As Vietnam is a dollarised economy, the mounting supply of foreign currencies resulted from high capital inflows since late 2006 had not only exacerbated dollarisation in the economy but also increased the total broad money in circulation, leading to inflation hike, making central bank's monetary policies more complicated. The central bank's efforts of forex intervention to relieve upward pressure on the local currency also played a part in raising the money supply in the economy, thus pushing up the inflationary pressure.

b. Overheated Credit Growth and Volatile Inter-bank Market

As a result of the strong surge in capital inflows, followed by great investment opportunities and greater local currency supply under a loosened monetary policy to neutralise abundant foreign currencies in the forex market, the growth rate of the Vietnamese banking system quickly mounted up from 25% in 2006 to 53% in 2007, and with domestic credit equaled to 98.3% GDP in 2007, instead of 40-75% of GDP as in the last period.

Table 5
Vietnam's Selected Monetary Indicators (2000-2007)

Indicators	2000	2001	2002	2003	2004	2005	2006	2007
Broad money supply (M2,% of GDP)		46.3	52.2	53.6	57.5	63.9	70.9	83.2
Broad money supply (M2,% yoy change)	39.0	25.5	17.6	25.0	30.4	28.8	28.9	37.8
Domestic credit (% of GDP)		39.7	44.8	51.8	58.2	69.8	75.0	98.3
Domestic credit (% yoy change)	38.1	23.2	25.6	32.4	31.0	40.6	24.7	53.0

In addition, the scarcity of VND in the banking system induced a fierce competition of interest rates, which then almost became a race among commercial banks, creating disorders in the banking system, segmenting the inter-bank market and worsening the partial liquidity problems.

c. Boom and Price Bubble in Real Estate and Stock Market

The surge of capital inflows in 2006 and 2007 was seen as one of the main sources of the price bubble in the real estate market and the boom of the stock market in Vietnam in the same period. The VN Index increased nearly six times and the daily trading volume in Vietnam’s stock market grew up more than 10 times just within one year. The fast growth of these markets in 2006 and 2007 fuelled inflationary pressure and induced the growing demand for risky investment into these markets, risking social and economic consequences should the bubble collapse.

Figure 10
Vietnam’s Booming Stock Market



(ii) Central Bank’s Response

In order to contain inflation, the SBV started tightening its monetary policies by sharply increasing its directive interest rates, restricting credit expansion and raising reserve requirements. SBV’s base interest rate was raised from 8.25%/annum in 2007 to 8.75%/annum in early 2008 and then quickly was lifted to 12%/annum in May 2008 and continuously to 14% one month later. SBV’s financing rate and discount rate were also adjusted upward in accordance with movements in the base interest rate.

Table 6
SBV's Directive Interest Rate Adjustment (2006-2008)

	2006	2007	2/2008	19/5/2008	11/6/2008
Base Rate (%)	8.25	8.25	8.75	12	14
Refinancing Rate (%)	6.5	6.5	7.5	13	15
Discount Rate (%)	4.5	4.5	6	11	13

The reserve requirement was raised from 5% to 10% as applied to local currency and up from 8% to 10% as applied to foreign currencies in June 2007. Both reserve requirement ratios were increased by an additional 1% in February 2008. The scope of reserve requirement was expanded to include deposits of all maturities.

In order to help stop the interest rate race among commercial banks that emerged in February 2008, the SBV temporarily required all commercial banks to maintain deposit interest rates not exceeding 12%/annum to regain the stability of money flows in the inter-bank market. Accordingly, the interest rate race quickly ended, depositors had no demand for shifting their deposits among banks and SBV's interest rate ceiling was rescinded immediately. The SBV then coordinated with the Vietnam Association of Banks for commercial banks to hold dialogue and reach consensus on maximum rates for deposit mobilisation so as to stabilise the inter-bank monetary market.

Besides, the SBV tried to sterilise the adverse impact of its forex intervention on inflation pressure through many ways, such as open market operations, increase of commercial banks' required reserve ratio, sale of central bank bills to commercial banks with diversified maturities from 14 days to 364 days in order to draw money back from circulation.

In February 2008, the SBV issued and required commercial banks to buy central bills with the total value of VND 20,300 billion (equivalent to approximately US\$1.28 billion). Banks had over one month for fund resource preparation. They could even borrow money from SBV to buy adequate central bank's bills as required. Banks operating at rural areas or owing small amount of own capital (less than VND 1000 billion) were not required to buy central bank's bills.

In order to calm down the overheated credit growth and consolidate the soundness of the financial system, the SBV issued comprehensive instructions

and implemented specific measures to monitor and control the scale, quality of banking credit, especially bank lending for high risks areas, such as stock investment and stock trading. Commercial banks were advised to keep credit growth below 30% for the whole year 2008. Under the directive of the central bank issued in July 2007, commercial banks' total outstanding loans for stock investment and stock trading and loans guaranteed by stocks were restricted below 3% of their total outstanding loans. Since February 2008, the banks' total outstanding loans and commercial papers discounted for the purpose of stock investment are not to exceed 20% of their legal capital. Intensive inspection were carried out by the central bank to scrutinise the commercial banks' risky lending activities for consumption, stock, real estate investment and trading or credit guaranteed by stocks, with the purpose to ensure the safety of the banking system in the context of a booming market.

Concurrently while tightening monetary policy to curb inflation, the SBV increased its short-term liquidity support to the banking system through open market operations and other channel of capital funding. Funds were assigned with first priority for development of business, export activities, major national projects and for rural and agricultural development. Money was injected by the SBV on a timely basis into some small banks to help them overcome temporary liquidity difficulties and ensure the stability of the whole system.

4.1.3 Balance of Payment Sustainability

The dramatic increase of capital inflows into the economy accumulated a high capital account surplus for Vietnam, which was the crucial offsetting resource for its huge current account deficit. It helped to improve its overall balance of payment. However, the country's consumption of increasing capital inflows, particularly portfolio investment, also entailed a greater accumulation of its future external debt obligation, putting the economy under more volatile foreign currency positions.

The consumption of greater capital inflows not only pumped more foreign currencies into the economy but also pushed up the aggregate demand of the economy, especially for importing of machines, equipments, raw materials and luxury goods, thus contributing significantly to the country's widened trade deficit and deteriorated Vietnam's balance of payment sustainability. Vietnam's trade deficit suddenly climbed up to US\$14.1 billion for the year 2007, nearly tripling the amount of 2006, and reached the equivalent of 25.7% of its export revenues

for the same period, and continued to swell out to US\$14.8 billion just in the first half of 2008.

Table 7
Vietnam Balance of Payment (2000-2008)

Indicators	2000	2001	2002	2003	2004	2005	2006	2007
Current Account balance (\$billion)	0.6	0.7	-0.7	-1.9	-1.6	-0.5	-0.2	-7.0
Current Account (% GDP)	2.1	2.2	-1.9	-4.9	-3.4	-0.9	-0.3	-9.3
Trade Balance	0.4	0.6	-1.1	-2.6	-2.3	-2.4	-2.8	-10.4
Trade Balance (% GDP)	1.4	1.9	-3.0	-6.7	-4.9	-4.3	-5.1	-13.8
Capital Account Balance (\$billion)	-0.7	-0.3	1.1	4.1	2.4	2.6	4.5	17.5
Net FDI (\$billion)	0.2	0.1	1.6	1.3	1.3	1.4	1.8	6.6
Portfolio Investment						0.9	1.3	6.2
Net External Debt (\$billion)	-1.0	-0.4	-0.5	2.8	1.1	0.3	1.4	2.1
Currencies and Deposit							-1.5	2.6
Overall BOP	0.1	0.2	0.4	2.2	0.8	2.1	4.2	10.1
Gross FX reserves (\$billion end year)	3.0	3.4	3.7	5.6	6.3	8.6	11.5	20.0

(i) Central Bank's Response

The SBV proactively cooperated with other relevant ministries to seek solutions to curb the import increase and encourage exports. On the other hand, the SBV closely monitored developments of capital flows in and out of the country in order to predict fluctuations in the balance of payment. The SBV also actively intervened in the foreign exchange market to buy foreign currencies for building up its international reserve while easing upward pressure on its local currency at the same time.

(ii) Policies Effects

Due to SBV's flexible exchange rate and monetary management, Vietnam's monetary and forex markets as well as exchange rate and interest rate developments were gradually stabilised. The liquidity of the banking system was improved. The inter-bank market overnight lending rate quickly went up. However, these positive developments may coincide with a start of a declining trend in net capital inflows as a consequence of the worsening situation in the global economy and financial markets.

4.2 Implications of a Declining Trend in Capital Inflows for Central Bank Policies and Its Response

4.2.1 Exchange Rate Management Policy

(i) Implications

a. Pressure of Depreciation on Local Currency

Since the second quarter of 2008, Vietnam witnessed a sign of decline in net capital inflows into the economy, mainly in net portfolio inflows. This led to a decreasing supply of foreign currencies available in the economy. Meanwhile, the demand for foreign currencies continued to increase as the trade deficit kept widening until the middle of the year. The VND was facing serious downward pressure in both the official and black markets.

Turning from negative foreign currency positions maintained in the previous period, when the local foreign exchange market was flooded by foreign currencies, the domestic banks were not well prepared for the sudden decline in net portfolio inflows, especially for the demand of short-term capital withdrawal out of the country. Hence, banks encountered a shortage of foreign currencies to meet the demand of importers and short-term foreign investors who wanted to convert their funds into foreign currencies to transfer home. The local currency was, therefore, under depreciation pressure.

Consequently, the exchange rate escalated to exceed 19.000 VND/US dollar in the black market while the SBV's reference rate was still at 16.500 VND/US dollar, followed by the quoted trading exchange rate of commercial banks to be kept at around 16.800 VND/US dollar as bounded by the controlled trading band of 1%. Meanwhile, the 1-year forward exchange rate of US dollar/VND in VND's overseas NDF market mounted up to 23.000 VND/US dollar.

Most of the economy's important demand of foreign currencies relied on the supply of the central bank. Trading volumes in foreign exchange market dropped dramatically both in inter-bank and retail market.

The SBV was once again facing serious difficulties in maintaining the stability in the foreign exchange market, but this time to protect the local currency from strong depreciation while preserving their foreign exchange reserve. This situation was not only the result of net portfolio investment decline but also of speculative activities in the foreign exchange market.

(ii) Response

The SBV continued implementing flexible exchange rate policies through flexible adjustment of exchange rate levels and trading bands as well as intensive foreign exchange intervention.

a. Exchange Rate Downward Adjustment

In parallel with selling US dollar into the market to improve its foreign exchange liquidity, the SBV proactively adjusted its reference exchange rate upward gradually in alignment with market developments. Specifically, the SBV's reference rate were strongly adjusted upward twice by 2% and 3%, respectively, in June and in December 2008 in order to better reflect the balance between demand and supply in inter-bank foreign exchange market. Around the same time, the controlled trading band was also widened from $\pm 1\%$ to $\pm 2\%$ to give more room for commercial banks to adjust their trading rates in accordance with market fluctuations. Besides, the depreciation of VND was also aimed at export promotion in the context of the global economic recession.

After each adjustment, the SBV's reference exchange rate was maintained relatively stable to signal the market about a period of stabilisation. On the other hand, the central bank tightened its supervision to request commercial banks to comply with the official trading band, fix the cross-exchange rate with the third currencies based on the US dollar/VND exchange rate, and not to add fee to raise the actual traded exchange rates.

Table 8
SBV's Exchange Rate Adjustment

Time of Adjustment	Permitted Trading Band (against IWAER)
25/2/1999	+ 0.1%
1/7/2002	± 0.25%
2/1/2007	± 0.5%
25/12/2007	± 0.75%
10/3/2008	± 1%
11/6/2008	± 1 %; increase IWAER by 2% (322 d/USD) for one time from 16139 -> 16461
27/6/2008	± 2%
07/11/2008	± 3%
24/12/2008	± 3% and increase IWAER by 3% from 16494 -> 16989

b. Intensive Foreign Exchange Intervention

The SBV aggressively intervened to stabilise the domestic foreign exchange market and defended its exchange rate regime by selling foreign currencies to commercial banks, thus reducing the imbalance between the demand and supply of foreign currencies and improving the market's foreign currency liquidity. Besides, the SBV continued to closely monitor commercial banks' daily net open position and used it as a basis for intervention consideration.

4.2.2 Monetary Management Policy

(i) Implications

The decline of net portfolio capital inflows into Vietnam impacted on the Vietnamese stock and real estate markets in two significant ways. Firstly, it led directly to a decrease in the total trading volume of the stock market, which used to rely considerably on the purchasing power of foreign investors. Secondly, it badly affected the sentiment of local investors in the stock and real estate markets.

The sharp fall of stock and real estate prices created great difficulties both for sectors in raising funds for their business operations and for the Government

in implementation of its schedule for state-owned enterprise equitisation. It exacerbated the adverse impact of the on-going tightening monetary policy on economic growth.

The massive sale of government bonds by foreign investors, on the one hand, created some disorder in the domestic monetary market and created pressure on the local currency in the foreign exchange market. On the other hand, it brought about opportunities for the local banks to buy government bonds at a low price, improving their balance sheets, increasing instruments for them to participate in open market operations with the central bank.

(ii) Response

In order to cope with the potential threats and adverse impact arising from uncertainties in the global financial market, recession in the world's economy and the threat of capital flight, the SBV proactively implemented comprehensive measures to consolidate the banking system, facilitate major economic activities and promote exporting industries. It adopted flexible but prudent monetary policy to maintain its primary objective of inflation control. Besides, the SBV proactively took prudent measures for controlling the pace and quality of credit growth as well as in tightening the prudential regulations for banks.

Since the fourth quarter of 2008 when the monthly CPI index showed signs of declining, the SBV started to gradually loosen its monetary policy to promote lending activities to stimulate economic growth in the context of global economic recession and drastic fluctuations in the world's capital market.

Within a period of three months from late October 2008 to January 2009, the SBV cut its target interest rates six times from 14% to 7% as applied to the base rate, from 13% to 6% as applied to the discounting rate, and from 15% to 8% as applied to the refinancing rate.

The reserve requirement ratio was lowered and lowered while the interest rate paid on the mandatory local currency reserve of commercial banks maintained with the central bank was raised from 1.2% to 3.6% (29/8/2008), 5% (24/9/2008), and then to 10% recently. The SBV also hiked the interest rates paid to the central bank's obligatory bills held by commercial banks to encourage commercial banks to lower their lending rates. The SBV also allowed commercial banks to use their holding of central bank's obligatory bills to participate in transactions of refinancing or clearing before expiration.

All these measures of the SBV were aimed at stimulating improvement in the capability of the banking system in capital mobilisation and credit extension, thus increasing liquidity, maintaining the sustainability of the system and contributing to domestic investment and economic growth stimulation. Furthermore, the Vietnamese Government and SBV resolved to apply a special policy of interest rate subsidy to facilitate individuals and institutions in maintaining and developing their production and business activities in the context of the global economic recession.

Additionally, a new set of policies were adopted to counteract the recession of the stock market and encourage the resilience of domestic investors in order to reduce the impact of foreign capital in the development of this important capital market.

4.2.3 Balance of Payment Sustainability

(i) Implications

The sudden decline in net portfolio inflows necessitated strong intervention by the SBV to stabilise the domestic foreign exchange market and protect the value of its local currency. The decline in net capital portfolio inflows directly impacted in lowering Vietnam's capital account surplus, contributing to a sharp deterioration in its overall balance of payment from a high surplus of US\$10.2 billion in 2007 down to \$0.5 billion in the first half of 2008.

(ii) Response

In order to maintain the soundness of Vietnam's balance of payment, the SBV actively cooperated with the other relevant ministries to implement comprehensive measures to curb inflation, promote exports and preserve its international reserve. The SBV established a new, fast daily reporting system through the commercial banks to monitor the movement of foreign portfolio investment.

Besides, various steps were taken by the SBV to improve its communication to the public. Foreign exchange reserves and monetary data was published and updated frequently on mass media. Weekly statements on monetary and banking operations were posted on SBV's Vietnamese and newly launched English-language websites. Regular press conferences and interviews were held by the central bank leaders to communicate the central bank's stance and new policy decisions regarding monetary and exchange rate policy. These moves of the

SBV has helped to bolster the confidence not only of the local people but also of foreign investors on the transparency, consistency of central bank policies and the stability of the banking system. The timely release of international reserve data, published the time first-ever, helped to allay the ungrounded concern of a sharp fall in Vietnam's international reserves that might lead to a potential crisis in its balance of payment.

4.3 Implications of Capital Flows Fluctuations for Central Bank Policies and Its Response

(i) Implications

The flexible movement of capital flows, especially portfolio investment, has increased the volatility of the forex market and the vulnerability of the financial and banking system.

As portfolio investment is usually of a short-term and volatile nature, it is also called hot money. It can flow in and out of the country very rapidly in response to changing conditions in the global and domestic economies and in the financial market. The flexible movement of short-term capital flows subjected the forex market to many unpredictable mini-shocks, continuously generating short-term shortage of demand or supply of foreign currencies and segmenting the forex market, thus creating difficulties for exchange rate and monetary policies and threatening the sustainability of domestic banking system.

(ii) Response

In order to protect the domestic economy and financial market from the adverse effects of the increasing flexible capital flows, the SBV enhanced its supervision and inspection over the money market and set up a fast reporting system to provide for appropriate market assessment and timely intervention. It gradually overhauled its banking supervision approach and reformed the structure and institutional framework of financial supervision. A specialised and dedicated Banking Supervision Agency and National Committee of Finance Supervision were established.

Additionally, the SBV took comprehensive measures to improve the liquidity of commercial banks both in VND and in foreign currency, and strengthened the resilience of the banking system to withstand the increasing fluctuation of international capital flows. The measures include:

- Enhancing controls for credit risk, especially credit extension for investment in securities and real estate.
- Promoting privatisation of state-owned commercial banks with a view to strengthening their financial capacity and improving their banking management capability.
- Modifying the regulations on the issuance of licenses for the establishment and operation of joint-stock commercial banks and foreign banks.
- Modifying the principles of loan classifications and setting detailed limitations on financial investment by credit institutions: Under the requirement of the SBV, by the year 2008, commercial banks were required to build internal credit-rating systems to facilitate their loan classification and credit quality management.
- Strengthening the financial capability of the banking system by setting out and implementing the following agenda of increasing the regulatory capital applicable for banks in accordance with the directive of the Prime Minister:

Table 9
Regulatory Capital Applicable for Various Types of Banks in Vietnam

No.	Type of credit institutions	2008	2010
1.	State-owned commercial banks	VND 3000 billion	VND 3000 billion
2.	Joint stock commercial banks	VND 1000 billion	VND 3000 billion
3.	Joint-venture banks	VND 1000 billion	VND 3000 billion
4.	100% foreign-owned banks	VND 1000 billion	VND 3000 billion
5.	Foreign bank branches	\$ 15 million	\$ 15 million
6.	Investment Banks	VND 3.000 billion	VND 3000 billion
7.	Development Banks	VND 5.000 billion	VND 5000 billion
8.	Cooperative Banks	VND 1.000 billion	VND 3000 billion
9.	Finance Companies	VND 300 billion	VND 500 billion
10.	Finance Leasing Companies	VND 100 billion	VND 150 billion

(Reference Exchange Rate: 1 US\$ = VND 16.900)

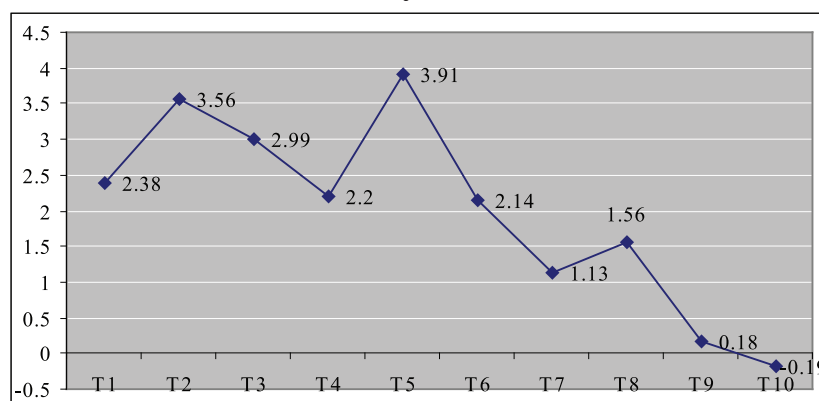
(iii) Policy Effects

Thanks to the appropriately flexible and prudent management of exchange rate, monetary policies and banking supervision enhancement made by the SBV, the Vietnamese economy quickly overcame the macroeconomic uncertainties.

Despite the adverse impact of the global economic recession and financial crisis and of the domestic macroeconomic uncertainties, Vietnam achieved a GDP growth rate of 7.4% in the first quarter of 2008. It recorded GDP growth of 6.3% for the whole year of 2008, a growth rate though lower than the previous year but still higher than that of many countries in the region and in the world.

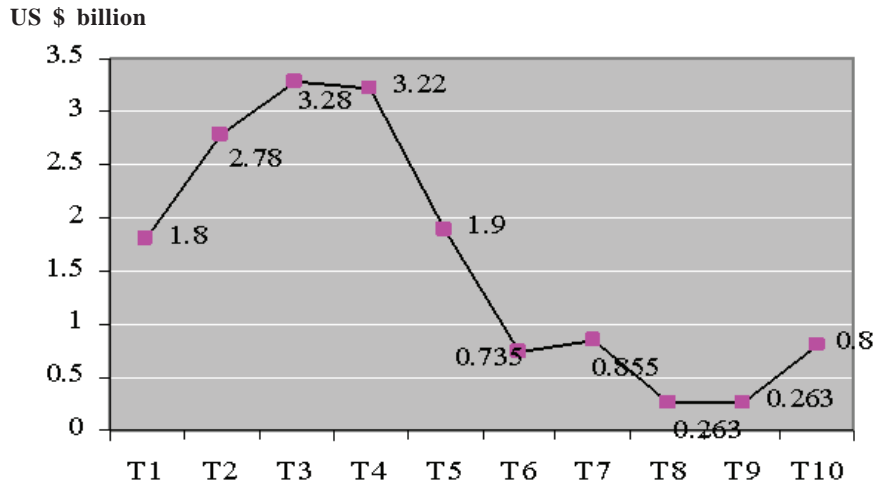
The SBV was successful in controlling inflation. The monthly CPI index was lowered to below 2% since July 2008, and turned marginally negative in October 2008. Inflation rate was 19.89% for the whole year 2008 in comparison with 2007.

Figure 11
Vietnam's Monthly CPI index in 2008



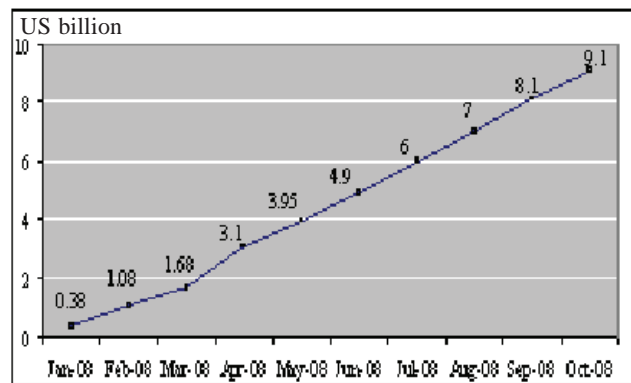
The trade deficit was gradually reduced and maintained under control. It remained below US\$1 billion since June 2008, and totalled US\$17.5 billion for the whole year of 2008. The overall balance of payment was slightly positive.

Figure 12
Vietnam's Monthly Trade Deficit in 2008



FDI inflows still increased to a record level attaining the registered amount of US\$59.36 billion in the ten months of 2008, of which US\$9.1 billion was realised . FDI inflows increased 38.3% against the same period of the previous year. This is evidence to show that foreign investors are still confident in the medium and long-term prospects of the Vietnamese economy.

Figure 13
Disbursement of FDI in Vietnam in 2008



The financial and banking system quickly consolidated both in scale and in depth, liquidity and solvency were maintained during the most volatile periods of capital flows fluctuations. Despite the fact that the international banking system is still struggling with liquidity problem, the Vietnam banking system was kept stable and safe without any bankruptcy or bank failures. The NLP ratio was about 3% of outstanding loans; the capital adequacy ratio was better than the previous year and nearly 10%. Money was injected by the SBV into some small banks which faced a liquidity shortage to restore their liquidity. The deposit and lending interest rate were quickly reduced both in wholesale and retail markets.

The commercial banks consolidated their internal inspection and audit control systems, enhancing internal monitoring. They adopted more prudent procedures in regard of loan evaluation and assessment. Credit quality as well as banks' corporate governance and management capability improved significantly.

The local foreign exchange market was quickly stabilised after each mini-shock in the supply or demand of foreign currencies due to capital inflow fluctuations. The exchange rate of US dollar/VND became quite stable around 17000 both in the official and parallel market. The differential between the exchange rate in the official and parallel market was insignificant.

With a fluctuation of over 9% of VND exchange rate in both ways (appreciating and depreciating) for the whole year of 2008, Vietnam's exchange rate policy was progressively more flexible but still under management. The SBV was quite successful in its innovative forex intervention strategy to stabilise the exchange rate and foreign exchange market. Though the intervention volumes were great during the years of 2007 and 2008, they did not deteriorate the national foreign exchange reserve, thanks to the SBV's appropriate management of reserve, buying in when market was over-supplied with foreign currencies and selling out when market was in shortage of foreign currencies. Confidence in the value of the VND and Vietnam's economic prospects was restored and strengthened.

5. Conclusion

Together with a fully liberalised current account, Vietnam removed many restrictions on its capital account, taking significant steps towards a liberalised capital account. Since its issuance of the first Law on Foreign Investment in 1988, Vietnam continuously amended and issued many relevant legal documents to create a transparent and favorable legal framework to encourage foreign investment, especially FDI into the country. Apart from some regulations limiting

the maximum level of participation of foreign investors in Vietnam's companies or in some special areas, Vietnam's Government does not impose any restrictions on capital inflows or withdrawals.

With its liberalised trade policies and a quite open capital account, Vietnam is well integrated into the world economy. Being a member of the AFTA, APEC and, most recently, the WTO, Vietnam has emerged as an attractive destination for global investors, especially in the period of 2006-2007, attracting an increasingly significant amount of foreign investment contributing to its economic development.

Since 1995 until now, Vietnam's capital account surplus has been rising (except 2000), of which, FDI is always the main part (except the year 2003). This is the advantage of Vietnam in maintaining a healthy capital structure, facilitating its sustainable economic development. However, the sudden surge of portfolio investment inflows into Vietnam since 2005 and their fluctuations trending downwards during 2008 are noteworthy and necessitated an appropriate policy response as it raised the proportion of short-term and volatile capital in Vietnam's capital structure.

Alongside the great opportunities for economic growth and market development that can be reaped from strong capital inflows, the increasing flexibility of capital flows in and out of the country posed tough challenges to the SBV. The greatest challenge may be the problem of the 'impossible trinity', which was clearly manifested in the difficulties of the SBV in maintaining the desired exchange rate stability and monetary autonomy under the impact of strong fluctuations in capital flows.

The mounting supply of foreign currencies that resulted from high capital inflows not only exacerbated the dollarisation in the economy, but also increased the total broad money, leading to inflation hike, overheated credit growth, price bubble in real estate and stock markets, making central bank's tasks in managing monetary policies more complicated.

The volatility of capital flows, especially portfolio investment, created instability in the domestic forex market by causing continuous shifts between short-term surplus and shortage of foreign currency supply and exerting upward and downward pressure on the local currency exchange rate. This not only made things more complicated for the central bank in the formulation and management of its monetary and exchange rate policies, but it also increased the volatility of the forex market and tested the soundness of the domestic financial and banking system.

The strong capital inflows, on the one hand, built up a high surplus in Vietnam's capital account, thereby serving as a crucial resource for its balance of payment improvement and facilitating its international reserve consolidation. On the other hand, they pushed up the demand for imports, thus deteriorating its trade balance.

In order to cope with the side-effects of the increasingly volatile capital flows, the SBV adopted flexible exchange rate policies, tightened monetary policies for inflation control and initiated comprehensive measures to improve the liquidity of commercial banks and enhance the central bank's supervision over the money market and banking system. Developments of capital flows in and out the country are subject to close surveillance by the SBV to prepare for any fluctuations in the balance of payment.

Due to the appropriate and timely response of the SBV, the Vietnamese economy rapidly surmounted the macroeconomic uncertainties. The economy grew by 6.3% in 2008 in spite of the adverse impact of the world's economic recession and the global financial crisis. Inflation was successfully controlled and the trade deficit was narrowed. FDI inflows still increased to reach a record level with the registered amount of US\$ 59.36 billion in the first ten months of 2008.

The financial and banking system consolidated rapidly both in scale and in depth, and liquidity and solvency were maintained during the most volatile periods of capital flow fluctuations. The commercial banks raised their working capital, consolidated their internal inspection and audit control systems, enhancing internal monitoring. They adopted prudential procedures in respect of loan evaluation and assessment. As a result, credit quality as well as the banks' corporate governance improved significantly. The local foreign exchange market stabilised quickly after each mini-shock in supply or demand of foreign currencies. Confidence in the value of VND and in the outlook of Vietnam's economic prospects was restored and strengthened.

Since the last quarter of 2008, Vietnam's economy was starting to be affected by the worsening global economic and financial situation. In this context, the SBV, once again, showed its promptness and flexibility when it proactively made a big policy shift from a tightened to a prudently loosened monetary policy and implemented comprehensive measures to stimulate demand and facilitate economic growth. Appropriate and massive measures were taken in a timely manner to mitigate the adverse effects of the external environment on the domestic economy.

The lesson of experience of Vietnam teaches us that the capital account liberalisation should be conducted in a gradual and orderly manner in alignment with a strengthened banking system and a flexible exchange rate mechanism. The macroeconomic policy adjustments should be carried out in a consistent and timely manner to help strengthen the sustainability of the financial system and promote confidence in the local currency, and to act as a cushion for unpredictable fluctuations in capital flows. The banking supervision and internal controls need to be further strengthened to prevent banks from taking risky or volatile positions. The quality and timeliness of the banks' reporting systems should be enhanced and the early warning system, both at the macro and microeconomic levels, should be quickly established to trace and prepare for any signals of instability.

While further efforts should be made to improve the trade balance so as to minimise the vulnerability of overall balance of payment to capital flight, a set of technical measures may be established to exercise indirect and effective control on hot money flows. Additionally, an effective and intensive public communication strategy can make a significant contribution to bolster public and investor confidence. The central bank's stance on monetary and exchange rate policy should be made more transparent to the public, which will help to protect the markets from psychological shocks. The public is to be made aware about the objectives and implications of macroeconomic policy adjustments to create consistent incentives for economic development.

According to the assessment of the world's leading financial institutions, such as the World Bank, the IMF, etc., in spite of the inevitable adverse impact of the global economic recession, Vietnam's economic prospects shine bright in the medium-term. Vietnam remains an attractive destination for global investors. Effective capital flow management is a tough, but critical task for Vietnam. It is a vital challenge for the country to meet, now and in the near future, if it is to get the most benefit from further integration and from globalisation of the international capital market, while minimising the side-effects.

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