Capital Account Liberalization for a Small, Open Economy -
The Case of Vietnam
Andreas Hauskrecht and Nhan Le¹, 2005

ABSTRACT

We survey the ongoing debate on pros and cons for an early and comprehensive liberalization of capital flows by emerging economies. We examine the main theoretical assumptions that would lead to positive effects on output growth and consumption volatility and reflect them with recent literature on market imperfections and information deficiencies. We find little evidence for a positive effect of free capital flows on economic growth and stability for emerging economies. We apply these main results to Vietnam as an example for an open emerging economy and discuss the main explanatory factors that may lead to negative impacts of an early and premature liberalization of capital flows. For small, open economies, absorption capacity for capital is limited. Excessive capital inflows might cause Dutch disease phenomena and asymmetric information might trigger an inefficient use of capital. In particular, we stress potential negative impacts of capital flows on the currency risk premium. Finally, we argue that for a partly dollarized economy as Vietnam a premature liberalization of capital flows might significantly increase financial sector instability. In conclusion, we emphasize the importance of a prudential sequencing of capital account liberalization and strong domestic institutions such as an independent central bank, proper financial regulation and supervision and macroeconomic stability as necessary pre-conditions.

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INTRODUCTION

In this paper we analyze the Pros and Cons of capital account liberalization for a small, open economy, using Vietnam as our reference point. We start by recording the expected benefits of liberalized capital flows and review the existing literature by analyzing the effects particularly on economic growth and consumption volatility for industrial and emerging economies. Overall, literature finds no or very weak evidence for positive effects of capital account liberalization on economic growth. Several studies identify early capital account liberalization as being detrimental for economic development. Subsequently we discuss possible factors that might elucidate these findings focusing on imperfect markets, asymmetric information, country risk, and macroeconomic imbalances as possible explanations. Afterwards we use Vietnam as a case study to apply our prior discussion and try to exemplify how the effective filtering of capital flows allowed importing significant benefits for the Vietnamese economy, while sheltering against increased capital flow volatility and its effect on domestic consumption.

EXPECTED BENEFITS AND SOBER REALITY

The belief of universal beneficial effects of free trade is commonly shared among (most) economists. In contrast, the effects of capital account liberalization for emerging economies are heatedly debated. Particularly in the aftermath of the Asian crises numerous studies questioned the promised benefits of capital account liberalization.

In theory, capital account liberalization should allow more efficient global allocation of capital, moving from industrial economies with vast capital to emerging economies where capital is scarce, from capital intensive to labor intensive countries where marginal return of capital is higher. This should be beneficial to industrial countries as rates of return should be higher, while emerging countries should enjoy elevated economic growth and rising employment. Also, capital inflows should smooth domestic savings volatility and therefore stabilize domestic consumption in emerging economies.

International diversification of capital (investment) should allow a better risk allocation transferring risk across countries. The enhanced ability to diversify risk should
spur total investment. Capital inflows also add liquidity to markets, lower the equity risk premium and cost of raising capital. Enhanced risk-sharing capacities should lead to higher degree of specialization.

Capital inflows, particularly in the form of FDI, should enhance the transfer of technology and managerial know-how; spillovers should have positive effects on productivity growth. Increased participation of foreign banks facilitates access to international financial markets. New financial instruments are introduced. The increased competition fosters efficiency of financial intermediation and should contribute to deeper and more liquid domestic financial markets. Finally, capital liberalization may serve as a credible commitment for good economic policies and should increase market.2

Yet, empirical studies of the effects of capital account liberalization produce ambiguous results. Potential benefits of capital account liberalization are difficult to measure, particularly in a cross-country framework analysis as countries might undertake a wide range of reforms simultaneously and it is hard to isolate the effects of having removed capital controls.3 It is also difficult to define the degree of liberalization or intensity of controls; the size of capital inflows is a misleading measurement as countries may enjoy significant capital inflows while strongly restricting the free flow of capital; China and Viet Nam are examples. Obviously, de jure liberalization of capital flows and actual capital movements are two different matters. Finally, capital restrictions and their removal should be seen in wider context of macroeconomic policies. To measure the isolated effects on one component of the package, here capital flows, is complex and may produce confusing results.

A few studies postulate positive effects of capital account liberalization on economic growth and consumption volatility.4 However, the observations made do not rule out the

3 For an extensive discussion of different methods use in measuring capital account liberalization effects see Edison et al. (2002), pp. 4-19.
possibility of reverse causation; more robust economic growth and macroeconomic stability might have been the foundation that leads to a liberalization of capital flows.

Most studies though find either no significant positive relationship between capital account liberalization and economic growth or even a negative relationship. Several studies find a negative relationship between free flows of capital and economic growth for developing countries, while there might be a positive relationship for industrial countries. Given the immense number of empirical studies with ambiguous results, the question is not if but rather why this is so? In the following section we analyze why capital account liberalization might be detrimental for a small, open economy, using Vietnam as a case, and discuss possible factors explaining this result.

**DIMENSION OF CAPITAL ACCOUNT LIBERALIZATION**

In the remainder of the paper we discuss different dimensions of capital account liberalization (alias financial market liberalization) for Vietnam, representing a small and open economy with robust economic growth.

From a theoretical perspective, the underlying assumption of the efficient-markets paradigm must be rejected when applied to capital flows for at least three reasons. First, when import-substitution industries are protected, capital might flow in inefficient sectors, causing immiserizing effects. Further, downward rigid real wages might cause an excessive allocation of capital into capital-intensive sectors with negative effects on domestic income. Presuming skilled labor being scarce in most developing economies, capital inflows might cause surge in demand for skilled labor and distort real wage levels,

5 The two most quoted paper reporting no or even negative effect of capital account liberalization on growth is Rodrik (1998). Edision et al. (2002) give a very detailed description of different techniques and data sets used in these studies, Prasad et al. (2004), Arteta et al. (2001) and Eichengreen (2001) survey the existing studies and all find no significant positive relationship.

6 Eichengreen (2001) and Prasad et al. (2003) stress this point.

7 Another strand of literature stresses the possible cost of capital account controls; see for example Forbes (2004). We do not follow this line of argument because it is a completely different discussion; the empirical observation of negative effects of free floating capital for emerging economies does not contradict with these conclusions. Capital controls might indeed be a second best solution.

resulting in eroding relative competitiveness of sectors with high skilled labor. Assuming the country being a price taker in world markets, production will shift from skilled labor to unskilled labor with lower value added.

Asymmetric information might be a major reason for misallocation of capital inflows (more on this below). These deviations from the efficient-market paradigm justify selective restrictions on capital flows as a suitable second best strategy.

**Forms of Capital Flows**

Capital account liberalization means foremost the possibility of free allocation of capital by domestic citizens and foreigners. These flows of capital take different forms such as foreign direct investment (FDI), portfolio investment (securities), bank loans, and transfers. An unrestricted inflow and outflow of capital has implications for the choice of exchange rate regime for a country. As we argue below, it is no coincidence that banking and currency crisis happen often relatively shortly after financial market liberalization. Observed pro-cyclical behavior of capital flows might increase domestic cost of capital. Finally, we will analyze possible implications and consequences of financial market liberalization for a partly dollarized economy.

The form of capital inflows and the market environment in the receiving country are decisive for potential effects; the Asian crisis has demonstrated how vigorously capital flows can fluctuate. Trading patterns in foreign exchange market such as herd behavior and noise trading are well documented in finance literature and expose small open economies to potentially very destabilizing capital in- and outflows.

*Foreign Direct Investment*

Economic literature stresses the positive effects of FDI on the receiving economy. One important reason is the long-term scope of such investment. In addition, investing in a foreign country demands proactive research in order to maximize information available on envisaged projects. FDI by its very nature tackles directly the overwhelming problem of asymmetric information. By placing managers in developing countries, multinational

9 Rajan and Subramanian (2005) stress this Dutch disease effect of capital inflows. They focus on the effects of Aid in their paper.
investors become insiders, thus being able to collect exclusive information to overcome this market anomaly.\textsuperscript{10}

\textit{Portfolio Investment}

The development of well functioning capital markets is even more challenging than the establishment of an efficient banking sector. Banks have the advantage of generating exclusive information about customers and base their risk management on the use of this information. In contrast, capital markets need to deliver good and reliable information to the public, as the potential counterpart for borrowers on the market. This information has to be based on robust fundamentals such as regulations and the compliance with which has to be strictly supervised. While this is generally true, it is a necessary condition before liberalizing access to capital markets by foreigners.

In the last decade, institutional investors have significantly increased their portfolio investment in emerging economies. Mutual funds are estimated to hold between 5 to-15 percent of market capitalization in stock markets around Asia, Latin America and transition economies.\textsuperscript{11} Dominant institutional investment raises the risk of trading anomalies and also contagious effects. If one country encounters an economic crisis, portfolio managers might withdraw investment from other countries with or without similar economic patterns as the crisis country, and thereby spread the symptoms of the crises among emerging economies.\textsuperscript{12} In consequence, capital account liberalization might increase and not decrease consumption volatility in emerging economies.

\textit{Exchange Rate Regime and Capital Mobility}

Among other things, the Asian crisis has demonstrated that capital market liberalization conflicts with a pegged (nominal) exchange rate regime. With free capital mobility it is easy for speculators to short domestic currency and leverage speculative pressure against the exchange rate peg. Speculators identify countries with conflicts of

\textsuperscript{10} For an application of the classical lemon pricing problem due to asymmetric information see Razin. et al. (1999). Agénor (2003) discusses FDI and its impact on the receiving country and reviews the existing literature.

\textsuperscript{11} Prasad et al. (2004), p. 13.

\textsuperscript{12} See for example Kaminsky and Reinhart (2003).
interests in their macroeconomic and monetary objectives such as the need to defend an exchange rate while unemployment is high or budget deficits are large. Speculators identifying such policy conflicts and potential domestic costs to defend the peg will start building up speculative positions. This is called a one-way-bet situation, as speculators may gain huge profits when the peg breaks while the costs are limited to the short-term borrowing costs of domestic currency and some transaction cost involved unwinding existing positions in case of an unsuccessful attack.

The shift from the exchange rate as the external nominal anchor to a domestic nominal anchor, usually introducing an inflation target as monetary policy commitment, is challenging. Inflation targeting regimes were first introduced by industrial countries; among the starters were Australia, Canada, New Zealand, and United Kingdom. More recently emerging economies have introduced an inflation targeting regime instead; examples are Brazil, Chile, and Philippines. The success of an inflation targeting regime depends firstly on the credibility of the central bank, its independence from politics pursuing a price stability oriented monetary policy; secondly on the accountability of the central bank in achieving the set range of inflation; and thirdly on a stable macroeconomic environment, particularly having prudential fiscal policy in place.

Particularly for small open economies, the exchange rate pass-through on domestic prices is significant. Hence, high fluctuations in the nominal exchange rate cause similar fluctuations in the domestic price level and are difficult to control by domestic monetary authorities.

For small, open, emerging economies, the nominal exchange rate is an important asset price; strong fluctuations of the nominal exchange rate undermine the quality of the domestic currency in its store of value function and cause capital flight into foreign currency. Hence, the fluctuations of capital flows translate into an increased volatility of domestic interests in emerging countries. Higher volatility in interest rates thereby raises effective cost of capital.\footnote{Stiglitz (2003b).}
International capital movements show a clear pro-cyclical pattern; strong capital inflows in good times with robust domestic economic growth are followed by hefty capital outflows in times of economic troubles.\textsuperscript{14} Recent studies show evidence of contagion of financial crisis in one emerging economy affecting other developing countries and increasing the country risk premium.\textsuperscript{15}

In response to the effects described above and also as an experience of the Asian crisis, many central banks worldwide have accumulated huge stock of international reserves. Figure 1 shows the foreign exchange reserves for selected Asian economies in April 2005. China alone has accumulated a stock of foreign exchange reserves of close to 660 billion USD. The accumulated stock of foreign reserves worldwide is estimated at 3-4 trillion US dollars. Although motives to increase foreign exchange reserves might be multifaceted, the overall trend of increasing international reserves has started long before

\textsuperscript{14} See Agénor (2003).
\textsuperscript{15} See for example Kamsky and Reinhart (2003) and Fiess (2003).
the US dollar began to depreciate in 2002; it would be misleading interpreting this trend as solely an attempt by those countries to hinder a further weakening of the dollar against domestic currency; rather this built up of international reserves has to be understood as an essential component of macro risk management in an environment characterized by volatile international capital flows in order to minimize its effects on emerging economies. It is also interesting to note that all countries listed in figure 1, with the exception of India, are net capital exporters.

This attempt of macro hedging against capital flow volatility comes with a high economic cost. Central banks usually invest foreign reserves, most of them denominated in US dollars, in the form of Treasury Securities or other highly liquid financial instruments with very low yields. In cases of strong capital inflows, central banks intervene in the foreign exchange market by purchasing foreign currency and thereby increase the domestic monetary base. In order to offset this effect, central banks sell domestic assets to drain domestic reserves and stabilize the domestic money supply. In other words, the central banks exchange high yielding securities for low yielding ones. If capital inflows become excessive and emerging economies run out of domestic assets (securities), central banks will start issuing central bank bills. The promised yield on these bills is usually considerably higher than the yields on comparable US securities. On a net basis, the central banks earn a negative yield on these operations; taking the current accumulated stock of foreign exchange reserves, this comes again with significant welfare losses for the economy.

Capital inflows significantly complicate domestic monetary policy. Many economists and the IMF point out the limited absorption capacity of capital inflows of emerging markets. Excessive capital inflows might cause Dutch disease phenomena: inflows of capital might cause the currency to appreciate and decrease competitiveness of exports; inflows might as well cause a shortage in the market of skilled labor and wages to increase and thereby reduce competitiveness of export industries using skilled labor.

Excessive capital inflows might increase risk premiums: as already discussed, volatility of interest rates induced by volatile capital flows increases the premium on cost.

16 For example Rajan et al. (2004).
of capital. In addition, the country risk premium is correlated with macroeconomic fundamentals; the premium decreases with rising economic growth and increases with rising government budget deficits and current account deficits (and US interest rates).\textsuperscript{17}

Net capital inflows might be offset by an increase of foreign exchange of the central bank (a capital export) or an equal decrease of the current account. A high negative current account is one factor arguably causing the country risk premium to increase. In a sense, high capital imports cause their own reversal. Obviously the positive effects of current account deficits on the country risk premium are closely linked to the Dutch disease argument as markets question the ability of a country to reverse trade flows with a given nominal exchange rate.

THE CASE OF VIETNAM

Although Vietnam restricts capital inflows and outflows, the country enjoys very robust inflows of capital.

Figure 2 plots the different sources of capital inflows for Vietnam for the years 1996 to 2003. The structure of inflows reflects a very effective filtering of volatile short-term capital inflows; short-term loans are effectively banned; medium- and long-term loans are small in volume and reflect basically lending from supranational institutions such as the World Bank.\textsuperscript{18} The two main sources of inflows are foreign direct investment and transfers, dominated by remittances from Vietnamese living abroad (Viet Kieu).\textsuperscript{19}

\textsuperscript{17}See Fiess (2003).

\textsuperscript{18}Montiel and Reinhart. (1999) analyze the motivation for capital restriction.

\textsuperscript{19}Remittances from Vietnamese living abroad are reported as a credit entry in the current account; consequently the counter-book entry in financial accounts private is a debit, therefore formally a capital export US dollars is a claim against the US. All other listed forms of capital inflows in figure 1 are debit/credit entries in financial accounts. Note that for a dollarized economy such as Vietnam the Balance of Payments does not catch the effect of an increase of dollar inflows as capital import (as these dollars are used domestically as parallel currency).
Vietnam enjoys a steady inflow despite tight capital restrictions. At the same time, Vietnam is able to shelter itself effectively from unwanted forms of volatile capital inflows. Loans and bond emissions in foreign currency are particularly critical as they contribute to a currency mismatch on a macro level and expose the economy to potential exogenous shocks, especially a depreciation of the domestic currency, the Vietnamese Dong (VND). Both sources of inflows are negligible for Vietnam.

Source: SBV, Ministry of Finance.

20 Hauskrecht and Hai (2004).
Table 1: Gross Investment per sector (in percentage)

<table>
<thead>
<tr>
<th>Sector</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004 (est.)</th>
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<tbody>
<tr>
<td>Total</td>
<td>100,00</td>
<td>100,00</td>
<td>100,00</td>
<td>100</td>
<td>100,00</td>
</tr>
<tr>
<td>State Sector</td>
<td>57,50</td>
<td>58,10</td>
<td>55,00</td>
<td>56</td>
<td>56,05</td>
</tr>
<tr>
<td>Private Sector</td>
<td>23,80</td>
<td>23,50</td>
<td>27,00</td>
<td>26,5</td>
<td>26,87</td>
</tr>
<tr>
<td>FDI Sector</td>
<td>18,70</td>
<td>18,40</td>
<td>18,00</td>
<td>17,5</td>
<td>17,09</td>
</tr>
</tbody>
</table>

Source: General statistics Office and Ministry for Planning and Investment

Table 1 shows gross investment by sector from 2000 to 2004. FDI has a stable and significant share of gross investment of 17 to 18 percent over the period. In 2004 the Foreign Enterprise sector contributed 33 percent (excluding crude oil) to total exports and 15.7 percent to overall GDP with rising tendency. FDI is evidently by a good part export-oriented and produces significantly higher rates of return than other investment in the economy, particularly than investment in the State Sector.

Table 2 shows FDI to Vietnam disaggregated for different sectors of the economy and as percentage of GDP from 1997-2003. Investment in the industrial sector dominates throughout the period. Although FDI as a source of capital inflow is small compared with China, it is still significant with a percentage of GDP per year between 10.8 percent in 1997 and 7.2 percent in 2003.
Table 2: Vietnam: Disbursements of Foreign Direct Investment, 1997-2003

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<tbody>
<tr>
<td></td>
<td>(In millions of U.S. dollars)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td>Industry</td>
<td>1,323</td>
<td>883</td>
<td>911</td>
<td>968</td>
<td>1,252</td>
<td>1,621</td>
</tr>
<tr>
<td>2000</td>
<td>Heavy industries</td>
<td>707</td>
<td>488</td>
<td>469</td>
<td>536</td>
<td>644</td>
<td>1,108</td>
</tr>
<tr>
<td>2002</td>
<td>Export processing zones</td>
<td>88</td>
<td>43</td>
<td>54</td>
<td>15</td>
<td>17</td>
<td>5</td>
</tr>
<tr>
<td>2003</td>
<td>Light industries</td>
<td>343</td>
<td>189</td>
<td>196</td>
<td>303</td>
<td>410</td>
<td>241</td>
</tr>
<tr>
<td>2004</td>
<td>Food</td>
<td>185</td>
<td>163</td>
<td>192</td>
<td>113</td>
<td>180</td>
<td>268</td>
</tr>
<tr>
<td>2005</td>
<td>Oil and gas</td>
<td>255</td>
<td>291</td>
<td>344</td>
<td>339</td>
<td>1,034</td>
<td>719</td>
</tr>
<tr>
<td>2006</td>
<td>Construction</td>
<td>436</td>
<td>220</td>
<td>182</td>
<td>209</td>
<td>49</td>
<td>46</td>
</tr>
<tr>
<td>2007</td>
<td>Transportation and communications</td>
<td>99</td>
<td>101</td>
<td>104</td>
<td>80</td>
<td>67</td>
<td>16</td>
</tr>
<tr>
<td>2008</td>
<td>Real estate</td>
<td>486</td>
<td>511</td>
<td>396</td>
<td>299</td>
<td>52</td>
<td>34</td>
</tr>
<tr>
<td>2009</td>
<td>Hotels and tourism</td>
<td>231</td>
<td>272</td>
<td>166</td>
<td>152</td>
<td>28</td>
<td>57</td>
</tr>
<tr>
<td>2010</td>
<td>Office property and apartments</td>
<td>255</td>
<td>240</td>
<td>230</td>
<td>147</td>
<td>24</td>
<td>4</td>
</tr>
<tr>
<td>2011</td>
<td>Agriculture, forestry, and fisheries</td>
<td>229</td>
<td>138</td>
<td>215</td>
<td>185</td>
<td>198</td>
<td>118</td>
</tr>
<tr>
<td>2012</td>
<td>Services</td>
<td>54</td>
<td>65</td>
<td>94</td>
<td>101</td>
<td>142</td>
<td>112</td>
</tr>
<tr>
<td>2013</td>
<td>Total disbursements</td>
<td>2,882</td>
<td>2,209</td>
<td>2,245</td>
<td>2,181</td>
<td>2,794</td>
<td>2,667</td>
</tr>
<tr>
<td></td>
<td>Memorandum item:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total disbursements (in percent of GDP)</td>
<td>10.8</td>
<td>8.1</td>
<td>7.9</td>
<td>7.2</td>
<td>8.2</td>
<td>7.2</td>
</tr>
</tbody>
</table>

Sources: Ministry of Planning and Investment (MPI); IMF.

In 2004, 71 percent of FDI was additional investment in existing operations within Vietnam, by far exceeding investment in new projects. This reflects advantages of enterprises already operating in Vietnam in gathering the necessary information as a basis for investment decision.

Registered remittances from Vietnamese living abroad back home are rising constantly since the early 1990s (figure 3). Some regulatory simplifications have supported this trend. In 2004 remittances from Vietkieu amount to more than 90 percent of yearly capital inflows to Vietnam. International investors of Vietnamese origin, most of them having close ties with families in Vietnam, enjoy an information advantage over other investors. They are insiders rather than outsiders; most transfers channeled through bank accounts are used for the purpose of self-financing projects in the small- and medium-sized enterprise sector. This is one important reason for the robust growth of the private sector although access to bank loans is still very limited.
Figure 3: Official Transfers from Overseas Vietnamese 1991-2004 (in millions of USD)


Figure 4 plots the Vietnamese Stock Market Index (VNI) since the formation of the stock exchange in HoChiMinh City from July 2000 to April 2005. Prices quintupled within a few months, then dropped close to starting levels shortly after; for almost 2 years, the VNI has shown a sidewalk around 250 points. The average daily market turnover is below 500,000 dollars, the overall market capitalization of the 28 listed companies, as of spring 2005, was around 0.2 percent of GDP (1,424 billion VND). The market value of all traded bonds reaches around 3 percent of GDP (20,000 billion VND). The stock exchange is not used as a means of rising capital but rather a pure secondary market. Foreign ownership in a company is restricted to 30 percent.

21 Note that Figure 4 data are partly inconsistent with data shown in figure 1. First, figure one shows all transfers, second, different sources deviate in data.
Several factors help explaining this modest development of stock market activity. To date, local corporations, including financial companies, apply Vietnamese accounting standards (VAS) that differ significantly from US General Accepted Accounting Standards (GAAP) or International Accounting Standards and are barely understandable for foreigners. For instance, according to VAS a credit default has not to be immediately recognized and realized in financial statements. This, of course, devalues the information content of those financial statements to a large extent.

A weak regulatory framework is accompanied by a similarly deficient supervision. One reason is the failure to understand modern financial economics; however, a supervisory body is always as good as the legal environment under which it is operating. Particularly law enforcement is weak in Vietnam. A foreign creditor prosecuting a legal claim needs a lot of patience before the case might be settled. In several cases the ruling seemed rather arbitrary.

A potential investor in Vietnamese stocks without insider information is practically investing into a black box. In such an environment, further liberalization of capital
market access for foreign investors is counterproductive, as it would merely increase volatility in stock market prices, but certainly not facilitate an efficient allocation of capital.\textsuperscript{22}

Countries enjoying high levels of capital inflows try to avoid an appreciation of the currency, causing a decline in export competitiveness by intervening in the foreign exchange market. As discussed in the previous section, foreign exchange interventions complicate liquidity management for the central bank. Figure 5 shows the net change of foreign exchange reserves of the State Bank Vietnam from December 2001 to October 2004 and changes in the monetary base over the same time period.

**Figure 5: Changes of Net Foreign Assets and Monetary Base, State Bank of Vietnam**

![Change Net Foreign Assets and Monetary Base](image)

*Source: State Bank of Vietnam*

Throughout the sample, the change in net foreign exchange reserves contributes significantly to the change in the monetary base, even exceeds in 2003 and 2004; in both years the SBV had to use Open Market Operations in order to sterilize excessive net capital inflows. So SBV exchanged domestic high yield securities for low yield US Treasuries. Note that this was necessary although relatively strict capital controls are in

\textsuperscript{22} Kaminsky and Reinhart (1999) stress the importance of prudential regulation and strong supervision as prerequisites of financial market liberalization.
place and a significant amount of foreign dollars stays in circulation outside the banking system.

**Table 3: Vietnams GDP by Source of Expenditure**

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
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<tbody>
<tr>
<td>In percent of GDP</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumption</td>
<td>49.62</td>
<td>75.24</td>
<td>73.51</td>
<td>71.27</td>
</tr>
<tr>
<td>Investment</td>
<td>47.65</td>
<td>56.82</td>
<td>54.74</td>
<td>37.06</td>
</tr>
<tr>
<td>Export-Import (net)</td>
<td>-8.53</td>
<td>-46.83</td>
<td>31.34</td>
<td>-7.62</td>
</tr>
<tr>
<td>Errors</td>
<td>11.27</td>
<td>14.77</td>
<td>3.08</td>
<td>-0.71</td>
</tr>
</tbody>
</table>

*Source: GSO and CIEM*

Table 3 shows the demand components of GDP for Vietnam in 2001-2004. Net capital inflows put Vietnam in the position of being a net consumer. Similar to other Asian countries, Vietnam has a relatively high domestic saving rate. From this perspective, the benefits of additional capital inflows in order to increase overall savings are questionable.

Vietnam is a partly dollarized economy. Figure 6 shows the trend of dollar deposits as a percentage of overall banking deposits for the period 1989-2003.

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23 Due to insufficient data State and Private Consumption and State and Private Investment are aggregated respectively.
Although several measures have been taken by the State Bank of Vietnam to fight currency substitution, dollarization remains relatively high at around 24 percent of bank deposits. A dollarized economy is extremely sensitive to changes in the exchange rate of US dollar. An unanticipated appreciation of the dollar could cause a collapse of the financial system. This exposure is not limited to currency mismatches in balance sheets of banks. Even though the consolidated bank balance sheet might show no currency mismatch, the risk would have been merely shifted to the final borrower. If borrowers are short in foreign currency while their income stream is denominated in domestic currency, these firms are now exposed to exchange rate (currency) risk. So from a bank’s view point, currency risk is changed into a higher default risk of borrowers. With the current practice in Vietnam of lending huge amounts of credit denominated in US dollars, a float

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24 This definition of dollarization underestimates the actual level of currency substitution as dollars outside the banking system are not included.
25 See Hauskrecht and Hai for a detailed discussion.
of the VND is not a viable option. A reverse of capital flows or a continuous increase in US interest rates would cause depreciation of the VND and trigger a wave of debt defaults and an implosion of the financial sector.

This brings us to the final discussion of Pros and Cons of capital account liberalization. Most commentators agree that liberalization is not per se positive for economic development; it depends on a careful sequencing of reforms as prerequisites; obviously a stable financial sector and robust macroeconomic fundamentals are among those preconditions for liberalizing capital flows. The Vietnamese financial system does show not only a high level of currency mismatches, but also a huge stock of non-performing loans and severely undercapitalized banks. A liberalization of capital flows is highly likely to trigger a stampede out of domestic banks and currency into safe haven such as foreign banks inside and outside Vietnam.

While the participation of foreign banks in domestic financial intermediation is not per se a bad thing, there is ample evidence that this comes with significant structural effects, such as a reduction in loans to small and medium size firms. This observation might be explained by information problems for foreign banks. A lack of information about small and medium sized domestic firms and understanding of their financial statements prompts international banks to ration credit to those potential clients. This is clearly not an argument against market participation of foreign banks; it simply restates the importance of information and transparency for well functioning financial markets.

CONCLUSIONS

Capital account liberalization for emerging economies is not an end in itself; rather it should be seen as a long-term objective. The main factors explaining deviation from theoretically derived beneficial effects of capital flow liberalization are market imperfections within emerging economies. Limited absorption capacity for capital might cause Dutch disease phenomena such as rising exchange rates and wages for skilled labor.

26 See Arteta et al. (2001) for a broader discussion.
Insufficient and asymmetric information might cause inefficient allocation of capital. Without a proper regulatory framework, effective supervision, and law enforcement, the effects of capital flows in emerging economies might even be detrimental.

International capital flows show a pro-cyclical pattern potentially increasing consumption volatility in emerging economies and raising the country risk premium. The effort to hedge against this capital flow volatility by piling up foreign exchange comes with significant welfare losses for developing countries.

We show for Vietnam a very effective system of filtering capital inflows, allowing long-term inflows such as FDI and private transfers while blocking short-term capital inflows. Although capital flows are significantly restricted, Vietnam enjoys a very robust inflow of capital that contributes significantly to the domestic saving rate. Both FDI and private remittances allow overcoming the existing information problems and increasing investment efficiency. Volatile short-term capital flows, particularly loans, are effectively blocked.

A switch to a more flexible exchange rate regime and implementing an inflation targeting seems premature. Particularly the currency mismatch in balance sheets and the non-performing loans in banks and corporations have to be solved as pre-conditions before next steps are taken.
LITERATURE


