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Capital Account Liberalization and Exchange Rate Policy Reform in Vietnam, 1990-2010*

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Abstract

The paper presents a comprehensive review of Vietnam's foreign investment and exchange rate policies. In particular, the paper gives an overview of capital account liberalization in Vietnam as it deregulated inward foreign direct investment flows (in December 1987), outward FDI flows (in April 1999), and foreign portfolio investment flows (in July1999). It shows that Vietnam, by liberalizing the capital account, has attracted a large amount of both FDI and FPI flows that appear to have played an important role in subsequent economic development. The paper also reviews Vietnam's exchange rate policy reform as part of banking and financial reform by summarizing important changes in the de jure and de facto exchange rate arrangements. It also shows how the foreign exchange market and the SBV's intervention operations evolved over the period 1990-2010.

JEL classification: F21, F31, O24

Keywords: Capital account liberalization, exchange rate policy, monetary policy, Vietnam

I. INTRODUCTION

The paper presents a review of Vietnam's foreign investment and exchange rate policies by paying particular attention to how the policies evolved over the period of economic renovation (*Doi Moi* in Vietnamese) that began in 1986. Indeed, *Doi Moi* has transformed the Vietnamese economy from a centrally planned to a market-oriented socialist economy and marked a turning point for the social and economic development of the communist country. During the period of economic reform, the government paid considerable attention to the financial and banking sector because reform in this

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sector was thought to create a favorable, transparent and sound business environment for enterprises and investors. To this end, one of the initial steps in economic reform in general, and in financial and banking reform in particular, was to liberalize foreign direct investment (FDI) into Vietnam and to make fundamental changes in the roles of the State Bank of Vietnam (SBV) in forming monetary and exchange rate policies, including a shift from a fixed arrangement to a managed float.

In reviewing Vietnam's foreign investment and exchange rate policies, the paper gives an overview of capital account liberalization as the country deregulated inward foreign direct investment flows (in December 1987), outward FDI flows (in April 1999), and foreign portfolio investment flows (in July 1999). It shows that Vietnam, by liberalizing the capital account, has attracted a large amount of both FDI and FPI flows that appear to have played an important role in subsequent economic development. The paper also reviews Vietnam's exchange rate policy reform as an integral part of banking and financial reform by summarizing important changes in the de jure and de facto exchange rate arrangements. It also shows how the foreign exchange market and the SBV's intervention operations evolved over the period 1990-2010.

The rest of this paper is organized as follows. Section II presents a comprehensive review of foreign investments in Vietnam including the process of capital account liberalization as well as developments in inward FDI, outward FDI and FPI over the period 1990-2010. Section III discusses exchange rate policy as implemented by the SBV, with a reference to the banking reform of which it was a part, and considers the de jure as well as de facto exchange rate arrangements of Vietnam, with a focus on how Vietnam's foreign exchange market and the SBV's intervention operations (to stabilize the dong's US dollar exchange rate) evolved over time. Finally, Section IV presents concluding remarks.

II. FOREIGN INVESTMENTS IN VIETNAM, 1990-2010

II.1. Evolution in the legal framework for foreign investment as part of capital account liberalization

II. 1.1. Liberalizing inward foreign direct investment (inward FDI)

Together with a number of other measures designed to transform Vietnam from central planning to market economy, the first *Law on Foreign Investment* was approved by the National Assembly on 29 December 1987. This marked a turning point in the country's regime toward inward foreign investment flows into Vietnam. The law was amended in 1990 and again in 1992 to give more rights and incentives to foreign investors, including: (i) equal tax treatment for joint venture and fully foreign owned firms; (ii) permission to invest in the construction of infrastructure; and (iii) longer duration of business operations. During the period 1988-1996, however, the volume of FDI inflows remained small, both in absolute value and as a percentage of GDP, likely owing to (i) limitations on the permitted forms of investment; (ii) high tax on the repatriation of income; (iii) and foreign exchange controls (e.g., documentary requirements for buying foreign currency).

In order to promote FDI inflows, the National Assembly passed a *Law on Foreign Direct Investment* on 12 November 1996 to replace the 1987 law. The 1996 law, as amended in June 2000, provided tax

Table 1. Successive Investment Laws Related to Inward FDI Flows in Vietnam

	Foreign Investment Law (1987)	Foreign Direct Investment Law (1996)	Investment Law (2006)
Scope	Inward foreign investment activities in Vietnam	Inward foreign direct investment activities in Vietnam	-Domestic investments -Inward and outward foreign investment activities
Forms of foreign investment	-Business cooperation contracts -Joint ventures -100% foreign owned firms	-Business cooperation contracts -Joint ventures -100% foreign owned firms; -Build-Operate-Transfer Build-Transfer-Operate; and Build-Transfer	-Business cooperation contracts -100% foreign owned firms -Joint ventures -Build-Operate-Transfer Build-Transfer-Operate; and Build-Transfer -Merger and Acquisition -Joint stock companies -Others
Foreign ownership	At least 30% with no upper limit	At least 30% with no upper limit	No requirements specified
Duration of business	-No more than 20 years -No more than 50 years (as amended in December 1992)	No more than 50 years; and 70 years for special cases	No more than 50 years; and 70 years for special cases
Investment licensing procedures	3 months	60 days	-Equity capital less than VND300 billions: 15 days -Equity capital more than VND300 billions: 30 days; no more than 45 days for special cases
Corporate income tax	-Exemption for joint ventures (and for 100% foreign owned firms after December 1992) for a maximum of 2 years after posting profits; and 50% reduction for up to 2 additional years -15-25% depending on the invested sectors and forms of FDI	-Exemption for FDI firms and foreigners in business cooperation contracts for a maximum of 2 years (4 years for special cases and 8 years for exceptional cases) after posting profits; and 50% reduction for up to 2 additional years (4 years for special cases) -10-15-20-25% depending on the type of sector	-Reduction and exemption of tax subject to special provisions -10-15-20-25% depending on the type of sector
Repatriation of capital and income	Allowed, subject to documentary requirements	-Allowed, subject to documentary requirements	Allowed, subject to documentary requirements
Tax on repatriation of income	5-10% depending on the amount of capital invested by foreign entities	-5-7-10% depending on the amount of capital invested by foreign entities -3-5-7% (as amended in Jun 2000)	Zero (per Ministry of Finance Circular 26 /2004/TT-BTC, 13 March 2004)
Exchange control	Foreign investor allowed to buy foreign currency at the official exchange rate announced by the State Bank of Vietnam (SBV), subject to documentary requirements	Foreign investor allowed to buy foreign currency at the official exchange rate announced by SBV, subject to documentary requirement	Foreign investors allowed to buy foreign currency at the trading exchange rate quoted by any licensed commercial banks in Vietnam, subject to documentary requirements
Account opening	FDI firms allowed to open VND and foreign currency denominated accounts at the Bank for Foreign Trade or foreign bank branches in Vietnam	FDI firms allowed to open VND and foreign currency denominated accounts at any licensed bank in Vietnam; or at banks located abroad in special cases	FDI firms allowed to open VND and foreign currency denominated accounts at any licensed bank in Vietnam; or at banks located abroad in special cases

Sources: Law on Foreign Investment (1987), Law on Foreign Direct Investment (1996), and Investment Law (2006)

incentives and greater rights to foreign investors in Vietnam by expanding the scope of investment, allowing a change in the form of investment (e.g., from joint venture to fully foreign ownership), allowing the opening of new branches beyond the headquarters, simplifying the licensing procedure, and the like. In general, the revision made in the *Law on Foreign Investment* during 1988-2008 aimed to remove obstacles to foreign investment and to create a more favorable environment for foreign investors. The government, in making these changes, may have been motivated by: (i) the country's critical need for capital for industrialization and modernization; and (ii) external pressure for international economic integration arising from bilateral trade agreements, bilateral investment agreements, and accession to the World Trade Organization (WTO).

The Law on Investment, approved by the National Assembly on 29 December 2005, took effect on 1 July 2006, providing a unified legal framework for both domestic and foreign investments in Vietnam. According to this law, foreign investment flows were for the first time classified as either foreign direct investment or foreign indirect investment (see Table 1on how this law compares with the previous investment laws).

II.1.2. Liberalizing outward foreign direct investment (outward FDI)

A country typically engages in two-way capital flows, with Vietnam being no exception. Before 1999, against the background of substantial FDI inflows, Vietnamese enterprises had carried out outward FDI projects in neighboring countries, such as Laos and Cambodia, even though the existing law only focused on inward FDI. In order to establish a legal framework for Vietnam's enterprises to invest abroad, on 4 April 1999, the government approved Decree 22/1999 to guide and manage outward FDI flows. At the same time, some legal measures were taken by the SBV (regarding foreign exchange management with respect to outward FDI projects) and by the Ministry of Planning and Investment (related to guidelines and practices for FDI outflows), which were all designed to assist Vietnamese enterprises with doing business abroad. Even so, outward FDI investors still faced difficulties and obstacles in implementing projects, including the cumbersome administrative procedures, and the lack of consistent and transparent rules.

In order to create a more favorable investment environment for outward foreign direct investors and to maintain the process of capital account liberalization, the government created a framework for outward FDI activities by approving the *Investment Law* (2006). As noted previously, this was made to apply to both inward and outward FDI, as well as to foreign portfolio investment. The general provisions of the *Investment Law* (2006) were made more specific by Decree 78 (2006), which gave comprehensive guidelines for Vietnamese enterprises investing abroad. Legally at least, this was an important milestone in the process of capital account liberalization in Vietnam (see Table 2 on how the 2006 measures compare with the previous law on outward FDI).

II.1.3. Liberalizing foreign portfolio investments (FPI)

The initial step in liberalizing foreign portfolio investment was the Vietnamese government's approval of Decision 145/1999 and Circular 132/1999 on the sale of stocks to foreign investors. These measures set preconditions for the establishment of the Hochiminh Stock Exchange in July 2000, but given the strict rules, the cumbersome administration procedure,[1] and the limited number of listed securities, they helped attract little foreign investment into the Vietnamese stock market. In view of

[1] Decision 145/1999 and Circular 132/1999 stated that foreign investors could re-sell or transfer stocks after one year if they did not take part in managing the company or after three years if they did so

Table 2. Successive Investment Laws and Other Legal Measures Related to Outward FDI in Vietnam

	Decree 22 (April 1999)	Decree 78 (August 2006)
Scope	Outward foreign direct investments	-Detailed guidelines for outward FDI only based on the general provisions of the Investment Law (2006)
Sectors for which incentives are given for outward foreign direct investment	All sectors, except banking, insurance and finance	All sectors, except special sectors listed by the government
Eligible investors	-State-owned enterprises -Cooperatives -Private enterprises, joint-stock enterprises	-State-owned enterprises -Cooperatives -Private enterprises, joint-stock enterprises, limited companies -FDI-related enterprises -Profit-based organizations related to health care, education, science, culture, and sports -Vietnamese households and individuals
Eligible sectors	All sectors, except banking, insurance and financial, press and media, and telecommunication	All sectors
Approving authority	-*Prime Minister* for outward investment projects of enterprises established by the government (usually state-owned enterprises) and those with more than US$1 million of equity capital -*Ministry of Planning and Investment* for all others	-*Prime Minister* for outward investment projects in banking, insurance and financial, press and media, and telecommunication enterprises in which the government owns more than VND150 billion of equity capital(equivalent to US$10 million based on the exchange rate at the time of approval) and those in all other sectors with more than VND300 billion in equity capital (equivalent to US$20 million based on the exchange rate at the time of approval) -*Ministry of Planning and Investment* for all others
Investment licensing procedures	-No more than 30 days	-No more than 30 days
Repatriation of income	Must be repatriated within 6 months from the end of each fiscal year in the host country; other special cases must be reported to the SBV	Must be repatriated within 6 months from the end of each fiscal year in the host country; other special cases must be reported to the SBV
Foreign exchange control	-Subject to the existing foreign exchange controls -No requirements specified on opening domestic bank accounts	Outward FDI investors must open an account at a Vietnamese commercial bank; capital must be disbursed abroad through that account and subject to foreign exchange regulations

Sources: Decree 22 (1999) on outward FDI flows, and Decree 78 (2006) on outward FDI flows

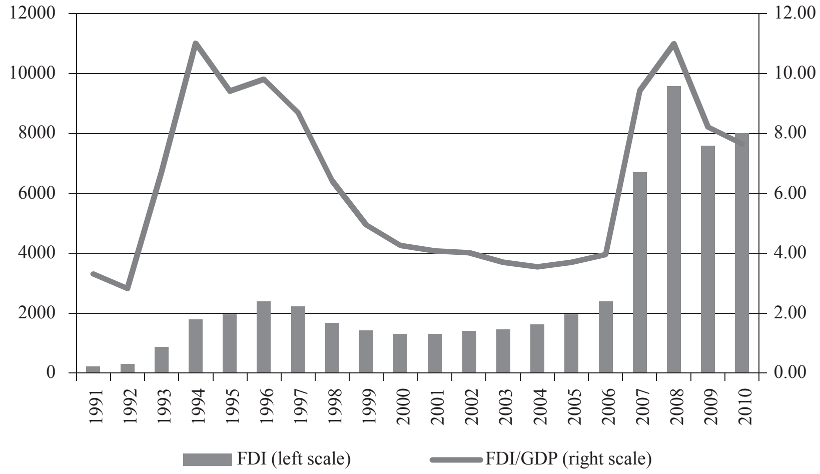
Figure 1. Capital Account Liberalization in Vietnam

Step 1: ***Liberalizing inward foreign direct investment***
-Foreign Investment Law (1987)
-Foreign Direct Investment Law (1996)
-The Investment Law (2006)

Step 2: ***Liberalizing outward foreign direct investment***
-Decree 22 on outward direct investment (1999)
-Investment Law (2006) and Decree 78 (2006)

Step 3: ***Liberalizing foreign portfolio investment***
-Decision 145 and Circular 132 on the sale of stocks to foreign investors (1999)
-Investment Law (2006) and Decision 88 (2009)

Figure 2. Developments in Foreign Direct Investment Flows into Vietnam, 1991-2010 (in millions of US dollars; in percent of GDP)



Sources: General Statistics Office of Vietnam; Vietnamese Ministry of Planning and Investment; author's calculations

this, the National Assembly approved the unified *Investment Law* 2006 as previously noted. A legal framework was thus established for foreign portfolio investment activities.

According to the *Investment Law* (2006), FPI is defined as "an investment through the purchase of stocks, bonds and other financial assets or through investment funds and other financial intermediates that are not involved in the management of the invested firms." In addition, the authorities introduced legal measures to create a favorable background for the further development of Vietnam's stock market, including: raising the limit on foreign ownership in Vietnam's enterprises, and eliminating foreign exchange controls on foreign investments. As a result, foreign investors were allowed to own as much as 49 percent (raised from 30 percent) of equity in listed companies (except in the banking and financial sector) from September 2005 and from June 2009 in unlisted companies. Thus, Vietnam now has a well-established legal framework for all types of foreign investment flows (Figure 1).

II.2. Recent developments in foreign investment flows

II.2.1. Inward FDI flows, 1991-2010

Cyclicality was observed in the volume of FDI flows into Vietnam for the period 1991-2010 (Figure 2). In the first half of the 1990s, FDI disbursements increased rapidly, from US$328.8 million in 1991 to US$1,956 million in 1995, and reached the peak of US$2,395 million in 1996. Following the Asian financial crisis of 1997-1998, disbursements gradually declined to reach US$1,298 million in 2000. The subsequent revival of FDI can be attributed to the strong recovery of other Asian countries from the crisis as well as to the conclusion of a bilateral trade agreement between Vietnam and the United States. The increase in FDI disbursements after 2006 was dramatic indeed: from US$2,400 million in 2006 to US$6,700 million in 2007, and to a record US$9,579 million in 2008 even amid the global economic crisis. The increase may have resulted from the country's accession to the WTO at

Table 3. Successive Investment Laws and Other Legal Measures Related to FPI in Vietnam

	Decision 145 and Circular 132 (1999)	Investment Law (2006) and Decision 88 (2009)
Scope	Selling stocks to foreign investors	-Domestic investments -Inward and outward foreign direct investment activities -Foreign portfolio investment
Forms of foreign investment	No definition specified	-Through the purchase of stocks, bonds and other financial assets, with no involvement in management of invested enterprises -Through investment funds -Through other financial intermediaries
Eligible foreign investors	-Foreign institutions -Foreign individuals -Oversea Vietnamese	-Foreign institutions, and its branches in Vietnam and foreign countries -Foreign investment related enterprises in which foreign ownership is more than 49 percent of equity capital -Investment funds, and investment companies in which foreign ownership is more than 49 percent of equity capital -Foreign individuals
Foreign ownership	-Limited to 30 percent in sectors related to agriculture, forestry, manufacturing, hotels, restaurants, tourism, transportation, health care, education, science, and technology	-*For listed joint stock company*: no more than 30 percent of equity capital, with maximum for a single individual, institutional and a single strategic institutional entity of 5 percent, 10 percent, 15 percent, respectively, in the case of the banking sector; no more than 49 percent in all other cases -*For unlisted joint stock company*: no more than 30 percent, with maximum for a single individual, institutional and a single strategic institutional entity is 5 percent, 10 percent, 15 percent, respectively, in the case of the banking sector; 30 percent, to be raised to 49 percent from 1st June 2009 (Decision 55/2009), in all other cases
Rights to resell or transfer stocks	After 1 year if they do not take part in managing the companies; otherwise, after 3 years	No requirements specified
Repatriation of capital and income	-Foreign investors are allowed to repatriate their capital after 1 year -Foreign investors are allowed to repatriate their income subject to documentary requirements after completing tax and other financial responsibility	Allowed, subject to documentary requirements after completing tax and other financial responsibility
Exchange control	Foreign investors are allowed to convert their income in dong into foreign currencies at any licensed commercial bank in Vietnam, subject to documentary requirements	Foreign investors are allowed to convert their income in dong into foreign currencies at any licensed commercial bank in Vietnam, subject to documentary requirements
Account opening	Foreign investors are allowed to open VND and foreign currency denominated accounts at any licensed bank in Vietnam; all transactions including buying and selling stocks, receiving and using dividends, repatriation of capital and income, and any other related to investment activities in Vietnamese enterprises must be made through these accounts	Foreign investors are allowed to open VND and foreign currency denominated accounts at any licensed bank in Vietnam; all transactions including buying and selling stocks, receiving and using dividends, repatriation of capital and income, and any other related to investment activities in Vietnamese enterprises must be made through these accounts

Sources: Decision 145 and Circular 132 (1999) on the sale of stocks to foreign investors, Investment Law (2006) and Decision 88 (2009)

Table 4. Foreign Direct Investment by Economic Sector, 1988-2008 (in percent of total)

	1988-1990	1991-1995	1996-2000	2001-2005	2006-2008
Total	100	100	100	100	100
Oil and Gas	27.2	5.8	12.8	0.8	14.6
Heavy industries and construction	4.4	26.4	26.0	38.3	33.2
Light industry (e.g., food processing)	8.0	15.6	11.8	25.7	6.8
Agriculture and forestry	24.7	8.3	4.7	8.8	0.8
Real estate	0.8	19.4	23.7	11.2	24.7
Services	34.7	24.4	21.0	15.2	19.9

Sources: General Statistics Office of Vietnam; Vietnamese Ministry of Planning and Investment; author's calculations

Table 5. Foreign Direct Investment by Form of Investment, 1988-2007 (in millions of US dollars; in percent of total)

	1988-1990	1991-1996	1997-2001	2002-2007
Amount (in millions of US dollars)				
Total	1412.7	20317	15911	45546
Joint ventures	927	14078	5162	4408
100% foreign owned projects	35	4670	7709	40023
Business cooperation contracts	450.7	1569	1662	527
Build-Operate-Transfer, Build-Transfer-Operate, and Build-Transfer	-	-	1228	483
Joint stock and shareholding companies	-	-	150	105
Composition (in percent)				
Total	100	100	100	100
Joint ventures	65.6	69.3	32.4	9.7
100% foreign owned projects	2.5	23.0	48.5	87.9
Business cooperation contracts	31.9	7.7	10.4	1.2
Build-Operate-Transfer, Build-Transfer-Operate, and Build-Transfer	0.0	0.0	7.7	1.1
Joint stock and shareholding companies	-	-	0.9	0.2

Sources: General Statistics Office of Vietnam; Vietnamese Ministry of Planning and Investment; author's calculations

the beginning of 2007. However, realized FDI inflows declined to US$ 7,600 million in 2009 against the background of global and domestic turbulences, though they picked up moderately to US$8,000 million in 2010.

Concurrent with these changes in the volume of FDI inflows, there was also a significant change in the composition of FDI projects by economic sector in Vietnam (Table 4). Oil and gas, agriculture and forestry, and services were the three most targeted sectors during the first stage of *Doi Moi* (1988-1990), and each of these sectors accounted for one fourth to one third of total FDI commitments. In later years, however, heavy industries and construction as well as real estate assumed greater importance as the sectors most attractive to foreign investors. It is apparent that labor-intensive sectors, such as light industry (including food processing), agriculture and forestry, have attracted only a small share of the FDI projects.

Table 6. Outward Foreign Direct Investment Flows, 1990-2010

Year	Number of newly registered projects	Registered capital (in millions of US dollars)	Implemented capital (in millions of US dollars)
1990-1998	18	13.6	927
1999-2005	131	559.89	
2006	36	425.29	
2007	64	391.2	
2008	113	3,000	400
2009	89	2,458	n/a
2010	107	2,926	900

Source: Vietnamese Ministry of Planning and Investment

Importantly, joint ventures constituted a significant majority of total FDI inflows into Vietnam in the early years (Table 5). Especially during 1988-1990 and 1991-1996, the joint-venture form of FDI accounted for nearly two thirds of total inflows. This reflects the fact that, during the period 1988-1996 when the initial Law on Foreign Investment was in force, the government favored joint-venture firms more than fully foreign owned ones by giving lower taxes, preferential credit, access to a greater number of sectors, and more simplified administrative procedures. After 1996, however, the share of joint ventures in total FDI commitments declined dramatically (e.g., only 10 percent during 2002-2007). An opposite trend was observed for fully foreign owned investments. Whereas their share in total FDI commitments was only 2.5 percent in the first stage of *Doi Moi*, it rose significantly to become the dominant form of FDI, with 88 percent during 2002-2007. Finally, investments under the so-called Build-Operate-Transfer (BOT), Build-Transfer-Operate (BTO), and Build-Transfer (BT) schemes, first introduced by the 1996 law, accounted for 7.7 percent and 1.1 percent of total FDI commitments, respectively, during 1997-2001 and 2002-2007. These forms of investment are concentrated in such highly protected industries as mining and petroleum (Tran, 2009).

II.2.2. Outward FDI flows, 1991-2010

Before the approval of Decree 22/1999 on FDI outflows (1990-1998), there were 18 outward FDI projects with the total registered capital of US$13.6 million (Table 6). At that time, all projects carried out by enterprises in provinces that share borders with Laos and Cambodia were based on bilateral cooperation agreements at the provincial level. After Decree 22/1999 took effect, FDI outflows increased dramatically in terms of the number of projects (from 18 during 1990-1998 to 131 during 1999-2005) as well as in terms of registered capital (from US$13.6 million to US$559.89 million). But FDI outflows increased even more rapidly follows the passage of the *Investment Law* (2006): from 36 projects with US$425.29 million in 2006 to a record of 113 projects with US$3 billion in 2008. After a global crisis-related decline in 2009, Vietnamese FDI investors invested US$2.926 billion abroad in terms of registered capital in 2010.The significant increase of FDI outflows in recent years, especially after the *Investment Law* of 2006 and Vietnam's WTO accession in 2007, indicates that Vietnam has been gradually integrating into the global financial market.

Table 7. Number of New Foreign Investment Funds and Newly Privatized Firms, 1991-1997

Year	No. of investment funds	Capital (in millions of US dollars	No. of privatized firms	Privatized capital (in millions of)		Ownership structure (%)		
				VND	USD[2]	State	Employees	Outsiders
1991	1	60	0	-	-	-	-	-
1992	0	-	0	-	-	-	-	-
1993	0	-	2	22,200	2.048	26.6	57.54	15.82
1994	4	270	1	4,793	0.436	30	35.2	34.8
1995	2	76.5	2	11,452	1.039	30.1	49.57	20.37
1996	0	-	6	19,032	1.724	n/a	n/a	n/a
1997	1	11.1	4	55,800	4.993	n/a	n/a	n.a
Total	8	417.6	15	113,277	10.240	n/a	n/a	n/a

Sources: Truong et al (2007), Nguyen (2007), and author's calculations

II.2.3. Foreign portfolio investment (FPI) flows, 1991-2010

II.2.3.a. The performance of foreign investment funds in Vietnam

1990-1997: Following the approval of the Foreign Investment Law in 1987, the program of "comprehensively open economic policies and privatization" (*Co Phan Hoa* in Vietnamese) launched in 1992 initially attracted FPI flows through eight foreign investment funds (Table 7). During the period 1990-1997, however, the average volume of FPI flows accounted for only 5.58 percent of disbursed FDI and only 0.37 percent of GDP. This poor performance can be explained by several factors. First, the Hochiminh Stock Exchange (HOSE) was not established until 1997. Second, the government moved only slowly to privatize state-owned enterprises beginning with small and medium sized firms and profitable or at least potentially profitable firms; large and strategic firms were initially excluded from privatization (Truong et al, 2007). Thus, foreign funds could invest only in a handful of privatized firms with a relatively small capital (Table 7). Third, the further opening measures which foreign investors had anticipated to be taken following the normalization of diplomatic ties between Vietnam and the US in 1995 did not happen. As a result, three of the eight investment funds moved out of Vietnam at the end of 1997.

1998-2002: This was a period of stagnation. Like most other Asian countries, Vietnam was adversely affected by the Asian financial crisis and saw a fall in the volume of FDI and FPI inflows. The Vietnam Enterprise Fund (established in Vietnam, July 1995), with a capital of US$35 million, was the only investment fund that maintained trading activities at a minimum level in Vietnam. Several factors explain the decline in foreign capital inflows:

(i) Concerns about the Asian financial crisis caused most foreign investors to withdraw from Asia, including Vietnam;

(ii) With critical remarks about the role of short-term speculative flows in precipitating the Asian financial crisis, the government took a cautious attitude toward FPI. In 1999, it encouraged FDI by

[2] The value of privatized capital in US dollars was obtained from dividing the dong figure by the average end-year exchange rate.

Table 8. Number of Foreign Investment Funds and Privatized Firms, 2002-2008

	2002	2003	2004	2005	2006	2007	2008	2009
No. of newly privatized firms	164	537	753	687	717	116	74	n/a
No. of foreign investment funds	3	5	7	11	23	30	n/a	n/a
No. of fund management co.	0	0	1	6	19	25	42	n/a

Sources: State Securities Commission of Vietnam, Truong (2007), Hoang (2008)

Table 9. Transactions by Foreign Investors in Vietnam's Stock Market

	2000	2001	2002	2003	2004	2005	2006	2007	2008
No. of listed stocks	2	3	17	22	26	32	108	253	342
VN Index	206.8	235.4	183.3	166.9	239.3	307.5	751.8	927.02	315.6
No. of foreign investors' accounts of which:	24	45	72	98	203	427	1700	8140	10000
Institutions	3	10	18	18	25	38	82	n/a	n/a
Individuals	21	35	54	80	178	389	1618	n/a	n/a
Net trading value (in billions of Vietnamese dong)[3]	0	14.5	146.9	252.7	463.7	202	7600	26153	6348
Net trading value (in millions of US dollars)[4]	0	0.96	9.56	16.2	29.47	12.72	472.3	1623	373.9
Percent of disbursed FDI	0	0.07	0.68	1.12	1.83	0.65	19.68	24.22	4.79
Percent of GDP	0	0.003	0.027	0.04	0.065	0.024	0.78	2.29	0.43

Sources: State Securities Commission of Vietnam, HOSE, HASTC, and author's calculations

offering incentives, but they did not apply to FPI;

(iii) Despite the establishment of the HOSE in July 2000, the number of listed stocks remained small and the stock market remained unattractive to foreign investors (Table 9); and

(iv) From mid-1998 to 2001, the privatization process moved more vigorously with 937 firms privatized, but only a small number of stocks were sold to outsiders including foreign investors (approximately 25 percent of privatized capital). Moreover, large and strategic firms in the banking, telecommunications, petro and aviation sectors were still held by the government.

2002-2007: This was is a period of "boom," especially from 2006. The privatization process was accelerated when the government allowed some large and "monopoly" firms in the banking, petro, and telecommunication sectors to be privatized in 2006. With accession to the WTO in January 2007, the government took steps to liberate markets in order to fulfill its commitments. In late 2006 and early 2007, against the background of strong economic performance, macroeconomic stability and a stock market boom, Vietnam became an attractive destination for both individual and institutional foreign investors, so that the number of foreign investment funds and fund management companies investing in Vietnam rose significantly (Table 8).

2008-2010: During this period Vietnam suffered from the negative effects of the global financial

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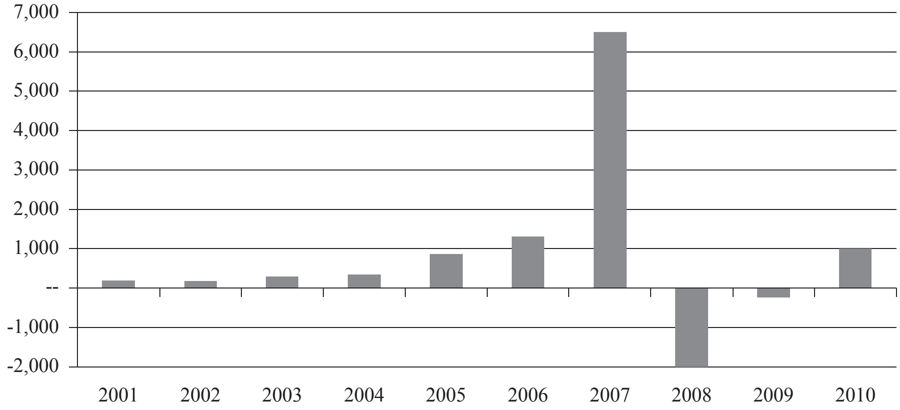
[3] These numbers are based on foreign investors' trading in listed stocks and bonds in HOSE and HASTC. Foreign investors' trading volume and value in unlisted stocks are not available.

[4] Net value in US dollars is obtained from dividing the net value in dong by the end-year exchange rate.

Figure 3. Foreign Portfolio Investment Inflows in Vietnam, 2001-2010 (in millions of US dollars)



Source: State Bank of Vietnam

crisis and domestic economic turbulences. Equity prices had tumbled by nearly 70 percent from January to December 2008, creating large losses for foreign investment funds, and caused some investment funds to withdraw from Vietnam. Although the country received a record US$ 6.5 billion in FPI inflows in 2007, there was a reversal of US$ 2 billion in 2008 and US$ 230 million in 2009 (Figure 3). This was followed by a renewed pick-up in 2010 as Vietnam's economy recovered and stock prices edged up.

II.2.3.b. Transactionsby foreign investors in the Vietnamese stock market

The establishment of HOSE (July 2000) and the Hanoi Stock Exchange (HASTC, March 2005) were important events that marked the further integration of Vietnam into the international financial world. Given the well-established legal framework and a more extensive program of privatization in the banking, aviation and petro fields led to a stock market boom after 2006. The number of listed stocks increased significantly from 32 in 2005 to 108 in 2006, and further to 668 at the end of 2010.

For the bond market, Moody's raised its rating of Vietnam's foreign-currency government bonds from B1 to Ba3 in July 2005; Fitch Ratings rated them at BB-. In October 2005, Vietnam successfully floated its first sovereign bonds with a 10-year maturity at 6.875 percent in the international market to raise US$750 million. Vietnam's domestic currency government bonds also attracted foreign investors because of high interest rates and the dong's exchange rate stability relative to the US dollar. 275 issues of government bonds with a maturity of more than 6 months were transferred from HOSE to HASTC and a market solely dedicated to the trading of bonds was formally established for the first time at HASTC in June 2008. As of 8 April 2011, 510 issues of government bonds were listed and traded at HASTC, with a total value of VND169.173 trillion (equivalent to US$8.05 billion).[5]

[5] Website of the Hanoi Stock Exchange: http://www.hnx.vn.

III. EXCHANGE RATE POLICY, 1990-2010

III.1. Monetary policy as background to exchange rate policy, 1990-2010

III.1.1. Banking sector reform, 1990-2010

As part of the program of economic renovation (*Doi Moi*) from1986, Vietnam reformed the financial and banking sector by establishing a two-tier banking system in 1988 under which the State Bank of Vietnam (as the central bank) was separated from four state-owned commercial banks. Until 1990, all banking services were provided within a centralized plan, however, so that the banking system was heavily regulated, largely ineffective and characterized by a lack of technological modernization and innovation (Jarvis, 2002). Moreover, the two-tier banking system did not function as expected because the SBV was still a part of the state bureaucracy. In order to create a more favorable legal environment for financial and banking activities in Vietnam, therefore, the government issued an ordinance on the SBV and an ordinance on banks, credit co-operative and finance companies in May 1990. Regulations by the SBV remained inadequate; however, and a rapid credit expansion ensued among ill-managed and ill-capitalized financial institutions. This led to a massive collapse of credit cooperatives, which harmed public confidence in Vietnam's banking system.

In order to overcome these difficulties, the National Assembly approved the *State Bank of Vietnam Law* and the *Credit Institutions Law* in December 1997, both of which came into effect in October 1998. In May 2005, moreover, the government made a decision to restructure the state-owned commercial banks, and convert them into joint-stock companies by 2010. This was expected to lead to a significant increase in the number and types of financial intermediaries, especially as wholly foreign-owned banks were permitted to enter the market under the WTO commitments. By December 2010, therefore, Vietnam's banking system had consisted of four state-owned commercial banks (two of which were privatized in 2009 with majority shares held by the government), a social policy bank, 37 joint-stock commercial banks, 48 branches of foreign banks, five joint-venture banks, five wholly foreign-owned banks, 17 finance companies, 13 financial leasing companies, 48 representative offices of foreign banks, a microfinance institution, and a system of 1057 credit funds.[6]

Although the banking system has played an important role in Vietnam's economic development, the legacy of central planning remains. The SBV is legally defined as one of the "ministries" of the government and pursues objectives assigned by the government.[7] Unlike most foreign central banks, the SBV is dependent on the government so that it does not enjoy the reputation required to anchor inflationary expectations. The commercial bank system on its part is yet to establish itself on a firm prudential foundation. At present, it has weaknesses in several areas.

First, although the capital adequacy of Vietnamese commercial banks meets the international standard of 8 percent, it is still lower than the regional average of 13.1 percent for Asia and the Pacific

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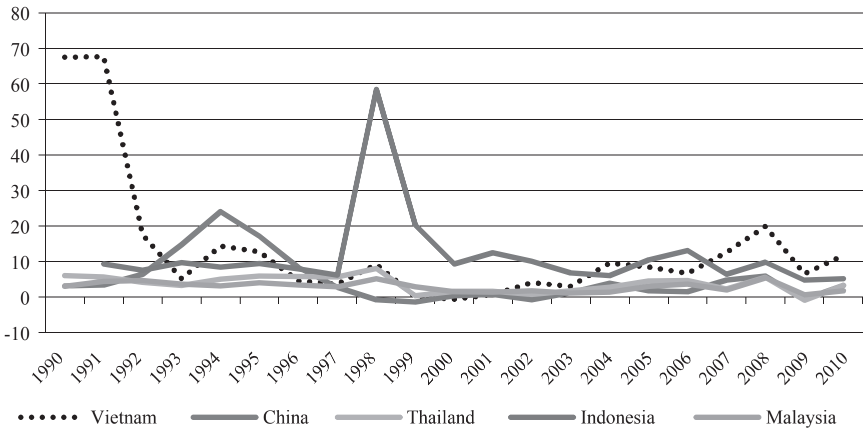
[6] www.sbv.gov.vn.

[7] For political reasons, the government may set economic objectives that come in conflict with each other, such as high economic growth and low inflation; high credit growth and low inflation; exchange rate stability, monetary policy independence and gradual capital account liberalization, etc. These complicate the mission for the SBV.

Figure 4. Inflation Rates in Selected Asian Countries (in percent per year)



Sources: www.gso.gov.vn; www.adb.org

and 12.3 percent for East Asia (Leung, 2009). Moreover, the size of commercial banks (in terms of equity) is still relatively small in comparison with other banks in Asia (the largest commercial bank in Vietnam has only about US$650 million in equity). With a weak financial capacity, Vietnamese commercial banks have difficulty in competing with foreign banks even in the domestic market.

Second, there is a large difference in equity size between state-owned banks (with an average of US$600 million) and joint-stock banks (US$100 million). As depositors prefer larger banks, smaller banks have a tendency to attract deposits by offering higher rates. At the time of a financial crisis, this has created fierce interest rate competition because larger banks also raised their deposit rates. The SBV has imposed a ceiling on deposit rates, but this has led to a distortion in the allocation of funds.

Third, financial services are not well diversified, with provision of credit remaining the main activity of commercial banks (e.g., turnover on credit operations accounts for 50-60 percent of gross turnover in commercial banks). In addition, non-performing loans in Vietnam's commercial banks are sizable (about 5 percent) in comparison with the average (2 percent) of commercial banks in foreign countries (Leung, 2009). Finally, management skills, especially liabilities and risk management skills, are still weak. Commercial banks tend to manage mostly short-term funds as long-term assets, creating a serious maturity mismatch and liquidity risk (Le, 2007).

III.1.2. Monetary policy goals and instruments

Vietnam has experienced a higher rate of inflation than most other Asian economies (Figure 4), with the result that the domestic currency tended to depreciate overtime. Thus, the primary objective of monetary policy during 1990-2010 was to control inflation and stabilize the exchange rate. Monetary policy was also directed toward stabilizing macroeconomic conditions and ensuring social welfare, especially during financial crises. In order to achieve these objectives, the SBV has used a variety of instruments, including credit limits (until 2005), reserve requirements, open market operations (from July 2000), interest rate instruments (the base interest rate, discount rate, and financing rate), and the official exchange rate, which are used as an indirect instrument and even a target in some cases.

1990-1996: Vietnam experienced severe economic difficulties during this period, such as rapid inflation,[8] large balance of payment deficits, and a series of credit cooperative failures. In order to create a favorable legal environment for the operations of the central bank, the government approved the *Ordinance on the State Bank of Vietnam* in which the term “monetary policy” was formally used for the first time. Although the SBV at the time was still following the old operating mechanism, the law clarified the objective of monetary management as that of stabilizing prices and the exchange rate.

1997-1999: Because of the negative effects of the Asian financial crisis, the SBV initially followed a contractionary monetary policy for controlling inflation, increasing the level of international reserves, and stabilizing the exchange rate. In 1999, the SBV shifted to a “carefully” expansionary policy stance as the country was about to experience deflation. The term “carefully” means that the SBV implemented an expansionary policy but they paid close attention on the movement of prices in order to keep inflation at a moderate level.

2000-2005: As the country came under deflationary pressure with low economic growth from mid-1999, the SBV followed a moderately expansionary policy stance. However, during 2000-2003, credit growth was targeted at 21-22 percent per year, but only 68 percent of the target was achieved in spite of a cut in interest rates. Because Vietnamese economic growth is critically driven by investment, of which domestic credit is an important determinant, this may in part explain the generally low economic growth during that time. In addition, domestic and global disturbances, such as a sharp spike in oil prices, the bird flu epidemic, and several natural disasters, may have been negative influences on economic growth in 2004 and 2005. Under these circumstances, the SBV continued to pursue an expansionary policy with the primary objectives of controlling prices while accelerating economic growth.

2006-2010: Accession to the WTO in 2007 created favorable conditions for the economic development of Vietnam. Moreover, a legal framework was gradually established for cross-border capital flows, with the *Ordinance on Foreign Exchange* (2006) and the *Investment Law* (2006). The global financial crisis and domestic disturbances, however, led to a deceleration of growth during 2007-2009.[9] Thus, the SBV switched between contractionary and expansionary policies, depending on the prevailing economic condition during this period.

III.2. De jure versus de facto exchange rate regimes in Vietnam

Until 1991, Vietnam, like any other communist country, participated in the internal market of goods and commodities among the socialist countries at soft prices set in term of the rouble. The Soviet Union had been Vietnam's main trading partner for many years. With non-convertible currencies, compensation trade was the dominant form, in which Vietnam relied heavily on the Soviet Union for many of its strategic imports (Brahm and Le, 1993). Under this system, the exchange rate was determined by comparing the internal and the external purchasing power of currencies and set by multi-party agreements among communist countries. In retrospect, the dong was overvalued during

[8] Inflation was 34.7 percent in 1989, 67.1 percent in 1990, and 67.5 percent in 1991.

[9] See Takagi and Pham (2011) for more details.

Table 10. Chronology of Vietnam's De Jure and De Facto Exchange Rate Regimes, 1990-2010

Time	De jure exchange rate regime	De facto exchange rate regime	Details
Before 1990	A fixed exchange rate regime	A fixed exchange rate regime	-Multiple exchange rates consisting of the official or trade exchange rate, non-trade exchange rate, internal settlement rate, and parallel market exchange rate -Exchange rates were unified in 1989 as the official exchange rate; the SBV devalued the official rate to be in line with the parallel rate: 1USD=4,500VND, with a margin of ±5%
1991-1996	A managed float	A simple US dollar peg	- The official exchange rate was around 11,000, with a margin of +0,1% (7/1994), ±0,5% (10/1994); and ±1% (11/1996).
1997-24 February 1999	A managed float	A pegged exchange rate regime with a horizontal band	- The trading bands were widened to ±5% (February 1997); ±10% (October 1997); +10% (January 1998); and +7% (August 1998) - The official exchange rate was devalued 4 times: 5.23% (February 1998); 3.92% (August 1998); 5.3% (December 1998); and 6.51% (26 February 1999)
25 February 1999-2004	A managed float	Managed floating with no pre-determined path for the exchange rate	- The official exchange rate was devalued by 6.51% on 26 February 1999, with a one-sided margin of +0.1% -Margin was widened to ±0.25% in July 2002
2005-2007	A managed float exchange rate regime based on a basket of currencies	Other conventional fixed peg exchange rate regime	-Margin was widened to ±0.5% (January 2007) and to ±0.75% (December 2007) - At the begining of each year, the SBV Governor announced a targeted change in the exchange rate of the dong over the forthcoming year
2008-2010	A managed float based on a basket of currencies	A simple US dollar peg[1]	- The official rate was devalued 5 times: 2% (11 June 2008); 2.9% (25 December 2008); 5.16% (25 November 2009); 3.25% (11 February 2010); 2.05% (18 August 2010); and 8.5% (11 February 2011) -Margin was changed 6 times: ±1% (10 March 2008); ±2% (27 June 2008); ±3% (7 November 2008); ±5% (25 March 2009); ±3% (26 November 2009); and ±1% (11 February 2011)

Note: See Takagi and Pham (2011) for more details.
Sources: www.sbv.gov.vn, and www.imf.org

this period, so that Vietnam had large chronic trade deficits. In the process of economic transition, in 1991, the Vietnamese authorities shifted the country's exchange rate arrangement to a more flexible arrangement, though the official rate was kept stable at around 11,000 per US dollar with a narrow trading band ranging between ±0.1 to ±1% during 1991-1997.

The Asian financial crisis of 1997 caused the currencies of many Asian countries to depreciate against the US dollar, which meant that the dong, still pegged to the US dollar, severely became overvalued against other Asian currencies. In order to improve competitiveness and thereby overcome its economic difficulties caused by the crisis, the Vietnamese monetary authorities switched to an exchange rate policy in which it combines strict foreign exchange controls and gradual dong depreciation.

Since 25 February 1999, the SBV has followed the practice of announcing on each working day an official US dollar exchange rate of the dong, along with a trading band, on the basis of the average actual exchange rates of preceding days in the inter-bank market. Over the period 1990-2010, the de jure exchange rate regime differed from the de facto regime as determined by the International Monetary Fund (IMF) (Table 10).

III. 3. Overview of Vietnam's foreign exchange market

III.3.1. Evolution of Vietnam's foreign exchange market

III.3.1.a. Before 1991

As noted previously, in 1988, Vietnam's banking system was separated into two tiers: the State Bank of Vietnam (SBV) and four state-owned commercial banks, including the Bank for Agricultural and Rural development (Agribank), the Industrial and Commercial Bank (Vietinbank), the Bank for Investment and Development (BIDV), and the Foreign Trade Bank (Vietcombank). As clearly implied by their names, the main activities of these state-owned commercial banks were concentrated in a particular economic sphere. Vietcombank is a unique bank having a license to operate in international banking, foreign exchange transactions, international settlement, and money transfers with foreign entities. Limiting the number of commercial banks operating in foreign exchange transactions explains why the foreign exchange market remained underdeveloped. Thus, Decree 161/HDBT on "Regulations in Foreign Exchange Management" was approved on 18 October 1988 in order to allow all state-owned commercial banks to do business in foreign exchange and international banking, and thereby removed the monopoly role of Vietcombank in this area.

III.3.1.b.1991-1994

Faced with a need to balance the demand for and supply of hard currencies as Vietnam began its transition to market economy, the government established Foreign Exchange Transaction Centres (FETCs) in Hanoi and Hochiminh City on 16 August 1991. The main objectives of the FETCs were:

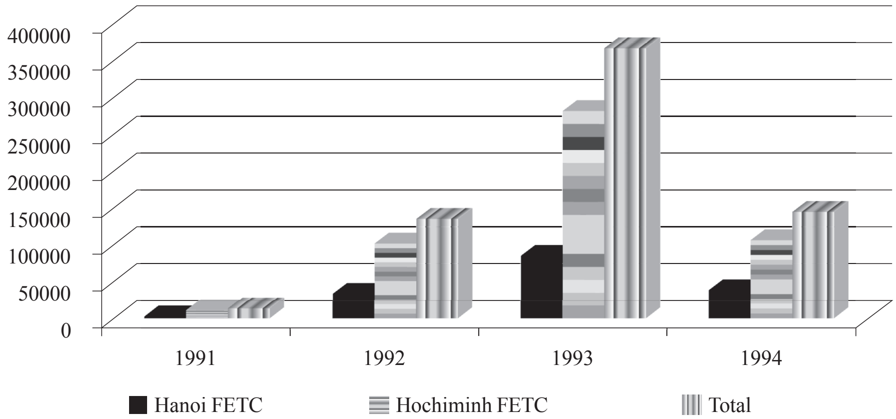
- Functioning as an organized market in which buyers and sellers could meet to strike deals with each other;
- Enabling the SBV to monitor supply and demand conditions and to form policies with regard to the management of monetary policy as well as foreign exchange reserves;
- Fixing realistic official exchange rates based on the actual market transactions; and
- Establishing the base from which a fully organized foreign exchange market could develop, with spot and forward quotes in all major currencies.

At that time, the FETCs only traded the dong against the US dollar and were managed by a board of managers consisting of representatives from the SBV and the four state-owned commercial banks with a foreign exchange license. The trading volume in the two centres, however, only remained small and accounted for about 10 percent of the total volume traded through the banking system. (Figure 5)

III.3.1.c.1994-2010

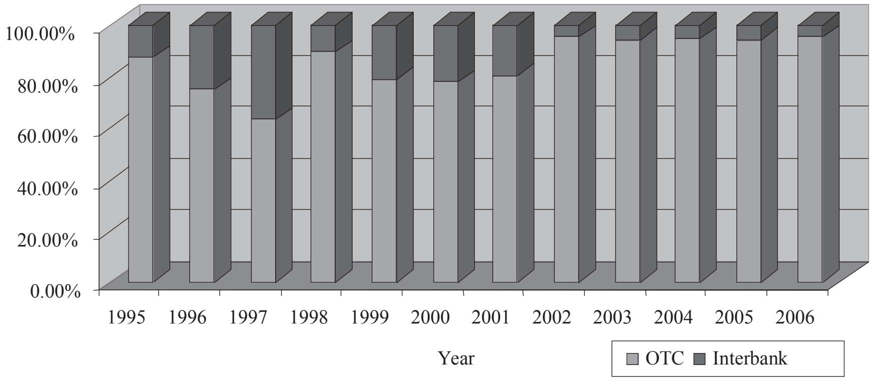
The remarkable economic achievements from the 1986 reform required a further development of Vietnam's foreign exchange market. On 20 October 1994, the SBV established an inter-bank foreign exchange market, initially with 24 members. Although it was expected to contribute to improving international trade as well as foreign investments between Vietnam and the rest of the world, the interbank market had only a modest role to play for the following reasons:

Figure 5. Trading Volume in FETCs, 1991-1994(in thousands of US dollars)



Sources: Annual Report of State Bank of Vietnam, annual issues

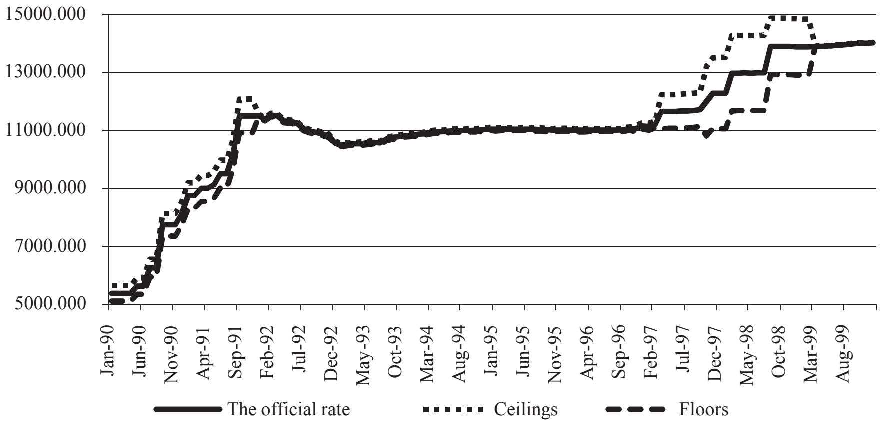
Figure 6. Trading Volume in the OTC and Inter-bank Markets (in percent of total)



Source: Annual Report of State Bank of Vietnam, annual issues

- Demand for US dollars always exceeded the supply, so the dong tended to depreciate against the US dollar over time.
- Although trading between the dong and other foreign currencies was permitted in the market, the majority of transactions (more 90percent) were between the dong and the US dollar.
- Spot transactions dominated the market with 95 percent of total trading volume, while the trading of forwards, swaps and options was relatively small, in part owing to the lack of familiarity with hedging on the part of market participants.
- The proportion of trading volume in the inter-bank foreign exchange market was small relative to trading in the over-the-counter (OTC) market (Figure 6), whereas interbank trading is much more important in the world's major markets. This implies that most foreign exchange trading in Vietnam was driven by direct trading with companies and individuals.

Figure 7. The End-Month Official Exchange Rate of the Dong against the US Dollar, 1990-1999



Source: State Bank of Vietnam

III.3.2. Intervention in Vietnam's foreign exchange market: sterilized or non-sterilized?

III.3.2.a. 1990-1999

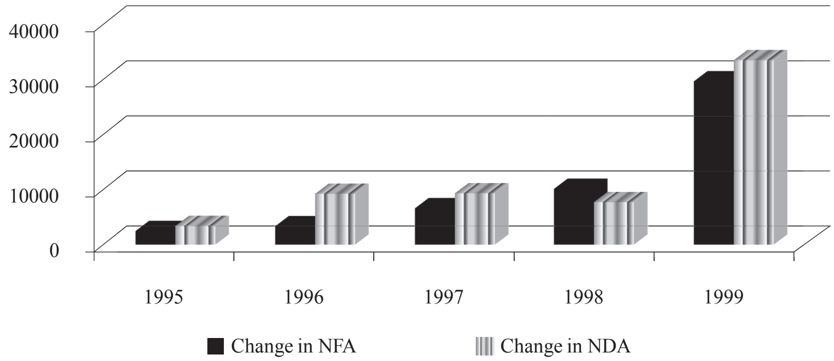
From 1992 to early 1998, the SBV attempted to maintain a stable official rate, which fluctuated narrowly around 11,000 dong to a dollar, in spite of the Asian financial crisis in 1997. However, while other Asian currencies depreciated significantly against the US dollar, the dong remained fairly stable, which led to a decline in the competitiveness of Vietnam's exports. At the same time, there was depreciation pressure on the dong, given the continuing current account deficits, a fall in FDI inflows, and inadequate foreign exchange reserves. To overcome these difficulties, the SBV gradually allowed the dong to depreciate while keeping strict foreign exchange controls.[10] In fact, the SBV devalued the official rate four times (Figure 7): (1) February 1998 (by 5.23 percent); (2) August 1998 (by 3.92 percent); (3) December 1998 (by 5.3 percent); and February 1999 (by 6.51 percent).

Sterilized intervention involves a change in the relative stocks of foreign and domestic assets held by the public, unaccompanied by any change in the monetary base. It is the standard practice of many central banks to sterilize the effect of foreign exchange market intervention though the use of open-market operations (OMO) in order to divorce foreign exchange from monetary operations. Because an open market did not exist until July 2000,[11] the SBV could not perform sterilized intervention during the 1990s by using the conventional method. Even so, the SBV paid close attention to the balance of net foreign assets (NFA) and net domestic assets (NDA) and used other means to achieve the target growth of broad money. Vo et al (2000), testing the impact of intervention in affecting the monetary

[10] In September 1998, the SBV limited the foreign exchange position of a bank to 30 percent of equity, and imposed foreign exchange surrender requirements of up to 80 percent of available balances (Decree 173/QD) in order to increase the supply of US dollars. Subsequently, the SBV reduced the requirements to 50 percent in August 1999 and then eliminated altogether in May 2003.

[11] Decision 85/2000/QD-NHNN14 on "Regulations on Open Market Operations" and Decision 608/2000/QT-SGD on "Procedure of Open Market Operations".

Figure 8. Annually Changes in Net Foreign Assets and Net Domestic Assets, 1995-1999 (in billions of Vietnamese dong)



Source: IMF, *International Financial Statistics*

base under the pegged exchange rate regime between 1993Q3 to 1999Q2, found that the offset coefficient was negative and ranged between -0.79 to -0.61. It is possible that, lacking the market instruments, the SBV was unable to fully offset the effect of intervention on the monetary base.

III.3.2.b. 2000-2010

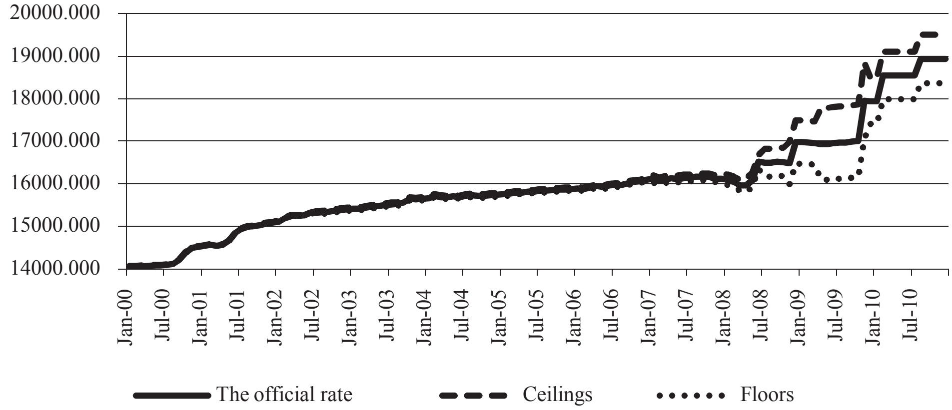
Although the US dollar depreciated against most other currencies (such as the British pound, euro, Japanese yen, and Thai baht), the dong slowly moved downwards against the dollar, as the government attempted to preserve relative competitiveness in the Asian-Pacific region as well as in the world. The SBV intervened in the foreign exchange market to achieve the exchange rate target, with the depreciation limited to around one percent over this period. Intervention was often substantial, but the resulting increase in the balance of net foreign assets was larger than the change in the monetary base. Ulrich (2005) thus concluded that the SBV had partially sterilized the effect of foreign market interventions.

In order to prevent the dong from appreciating as FDI and FPI inflows rose, the SBV bought more than nine billion US dollars in 2007, while selling Treasury bonds. At the same time, the SBV required commercial banks to increase compulsory reserves from 10 percent to 11 percent, and 41 commercial banks to buy 20,300 billion dong in 364-day compulsory SBV bills,[12] issued on 17 March 2008.[13] Unfortunately, the SBV's efforts to sterilize the effect of intervention were not entirely successful: total liquidity in 2007 increased by 46 percent in 2007 from 2006; high inflation, accompanied by depreciation pressure on the dong and large deficits in the trade and current account balances.

Several factors were at play. First, in 2007, the SBV believed that the excess supply of US dollars was temporary, and that it would be reversed at the end of the year because of high import demand.[14]

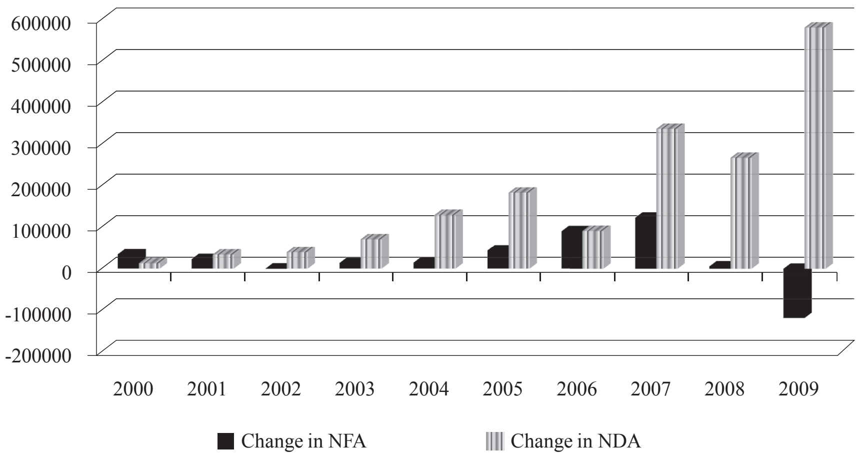
[12] Compulsory bills are bills that the SBV required 41 commercial banks to purchase at the rate of 7.8 percent (set lower than the prevailing market rate) in order to withdraw funds from circulation.
[13] See Takagi and Pham (2011) for more details.
[14] In Vietnam, a seasonal excess demand for US dollars has been observed for many years towards the end of the year.

Figure 9. The End-Month Official Exchange Rate of the Dong against the US Dollar, 2000-2010



Source: State Bank of Vietnam

Figure 10. Annually Changes in Net Foreign Assets and Net Domestic Assets, 2000-2009 (in billions of Vietnamese dong)



Source: IMF, *International Financial Statistics*

As it turned out, large investment inflows continued to come into Vietnam in late 2007 and early 2008, leading to a rapid growth in the domestic money supply. Second, in 2007, the SBV sold bills and bonds to withdraw funds from circulation, but this was not entirely successful, because: (1) the SBV's bills and bonds were not attractive to commercial banks because the interest rate was low and the maturities were not diversified; and (2) in late 2007 and early 2008, most commercial banks were short of dong funds. Finally, the liquidity injection facilitated a rapid private sector credit growth.

In view the excess supply of US dollars, the SBV in September 2008 began to purchase dollars to prevent the dong from appreciating and attempted to mop up excess liquidity through open market operations. In the meantime, the SBV continues to offer SBV bills with varying maturities ranging from 28 days to 364 days.

IV. CONCLUDING REMARKS

The paper has presented a review of the legal framework for and recent developments in foreign investments in Vietnam for the period 1990-2010. By looking at the process of liberalizing inward FDI, outward FDI as well as foreign portfolio investment flows, the paper has shown that Vietnam followed the conventional capital account liberalization process, namely, from direct to portfolio investment, and from long-term to short-term. The improvement in the legal environment has attracted foreign investors and led to a large inflow of FDI and FPI that contributed to Vietnam's economic development.

The paper has also reviewed Vietnam's exchange rate policy over the same period, as another pillar of the country's strategy toward the external sector. Exchange rate policy is always closely connected with monetary policy, but in the case of Vietnam the connection is particularly intimate. The paper has noted that the exchange rate is used as an indirect instrument or even as a target in some cases for monetary policy. The dual objectives of exchange rate and price stability assigned to monetary policy have from time to time presented the State Bank of Vietnam with a challenge. For example, the policy of allowing a moderate depreciation of the dong over time has come in conflict with the need to maintain price stability, as a weaker dong created inflationary pressure and rising input prices for Vietnam's industries.

The switch from a fixed peg (to the US dollar) to a managed float in the early 1990s can be understood in the context of capital account liberalization, as documented in the text. Given the well-known "impossible trinity" (i.e., the proposition in the economic literature that governments have only a limited ability simultaneously to pursue a stable exchange rate, an open capital account, and an independent monetary policy), the policies Vietnam chose to pursue after the beginning of *Doi Moi* in 1986 made it increasingly difficult to maintain a fixed peg as it also tried to maintain monetary autonomy. It is also possible that the Vietnamese authorities desired to conserve precious foreign exchange reserves as a buffer against adverse external shocks as it continued to open its economy. This paper has thus amply demonstrated the close connection between capital account liberalization and exchange rate policy for a small developing economy.

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