# CHAPTER 1

# INTRODUCTION

## 1.1. Introduction

The former National Bank of Vietnam (today's State Bank of Vietnam) was set up on the 6th of May, 1951. Over the past 40 years of operation, the banking system has developed from day to day in width as well as in depth thus meeting the needs of the country's national construction and defence. It has always tried progressively to improve professional activities so as to become the spine of the whole economy. The State bank plays three major roles: (a) cash center, (b) credit center and (c) payment center of the national economy. The banking system has made several improvements and several changes. But due to subjective and objective reasons, those efforts have bettered neither the economic activities nor the banks themselves.

As it was evaluated in the UNDP (United Nations Development Programme) report on the Vietnam economy "*Until 1988 very few changes have been recorded in the banking system. But since then, a series of renovation programs have been made public and caused influences on the institutions, control instruments, interest rate policy, money and the gold market. Those renovation programme have completely changed the face of the monetary and banking areas*".

In the period before 1988, the monetary and credit policies carried out in the framework of the money and credit plans have shown the inability to control inflation. Those plans drawn up at the macro economic level had ignored the pros and cons of the micro activities. In realizing their annual plans, the Banks are responsible for providing credit to state enterprises allowing them to fulfill their production scheduled figures in accordance with the credit value risen up during the year in order to meet price and wage changes. There were no efficient measures for controlling the money and credit excessive increase.

During the period 1986-1988 (before reform period), credit volume has increased at the speed of inflation, i.e, more than 300 per cent a year. The state enterprises were provided with the largest proportion of credit (87 per cent) while the cooperatives were only supplied with 10 per cent and private sector with 3 per cent. Credit provided for the working capital increased faster than for the fixed assets reflecting the fact that the production costs of the state enterprises increased due to the raise of salaries and input prices. Credits for fixed capital were constraint because since 1987 the State enterprises were only provided with credit listed in the State economic plans and had to spend at least 25 per cent of their earnings for such investment.

The working capital speedily increased faster than inflation due to the rapid expansion of cash in circulation which was about a half of the working capital. The other components of working capital were time deposits (about a half of the volume) and deposits in foreign currencies at the Bank for Foreign Trade (see Table 1).

US dollar and gold - the 2 financial capital kept for preventing inflation, could not be accounted in the money statistical figures, their selling or buying prices on the free market reflected and influenced price estimates. Moreover, they were used in border trade. Gold was used as payment for durable goods and medium-term bonds issued by enterprises.

The true status of the economy in 1986-1988 after the comprehensive price-salary-money adjustment was a gloomy picture: increasing budget deficit and credit outstanding super inflation, cumbersome money circulation, production depression, rocket prices, bad living conditions (see Table 2 and Table 3). The most direct and crucial causes of such a situation were the long existence of the administrative and subsidized management system. The economic management by means of orders was the most essential. Economic targets were arbitrarily imposed in the state plan for enterprises. The administrative authorities deeply interfered in production activities. Enterprises took no responsibility for their production and business, etc... For escaping from crisis the State undertook an all round programme of reform in Spring 1989. Such an achievement has fundamentally changed the economic management system thus creating a turning point that allowed reform to enter a new orbit. As a result, the overall reform program has increased the GNP by 7.1 per cent in 1989, the food yield reached 21.5 million tons, of which 1.4

**Table 1. Monetary survey 1986 - 1989**
(In billion Dong end of the period)

| | 1986 | 1987 | 1988 |
|---|---|---|---|
| **Foreign Funds** | **-23** | **-210** | **-277** |
| **Total Domestic Funds** | **134** | **680** | **2662** |
| of which: | | | |
| **Domestic credits** | **152** | **531** | **2663** |
| Governmental Agencies | 19 | 80 | 669 |
| Non-financial Public Entities | 177 | 376 | 1709 |
| Cooperatives | 13 | 44 | 171 |
| Private and household busines | 4 | 32 | 84 |
| Others | -18 | 149 | 29 |
| **Total circulating capital (M2)** | **111** | **471** | **2385** |
| Off - the - bank | 55 | 205 | 1024 |
| Savings (in Dong) | 54 | 238 | 1118 |
| Savings (in Foreign currencie | 1 | 29 | 242 |
| (% change of M2 outstanding | | | |
| at the end of the period) | | | |
| **Foreign funds** | - | **-169** | **-14** |
| **Domestic credits** | - | **343** | **446** |
| **Government** | - | **56** | **125** |
| **Non-financial public entities** | - | **234** | **283** |
| **Cooperatives** | - | **28** | **27** |
| **Private and household busines** | - | **25** | **11** |
| **Total circulating capital (M2)** | - | **326** | **406** |
| Of which: bank´s money | (135) | (174) | |
| Remarks: | | | |
| Savings (billion dong) | 7 | 53 | 152 |
| Money/GNP | 6.1 | 5.9 | 6.4 |
| Circulating capital (M2)/GN | 12.8 | 12.7 | 14.5 |

Source: Statistics by the State Bank of Vietnam million tons were exported. The target of controlling and pushing back inflation was fulfilled, i.e, the 3 digits inflation rate went down to 2 digits in 1989,(95 per cent) see Table 3.

On other hand, the impact of the reform has revealed the weakness of the management and the real financial state of economic organizations which had been existing for a long time under the subsidy regime. The production and business situation was turned upside-down. A series of state enterprises and small industrial units felt into stagnation and went bankrupt, debts dragged on. All that, rendered the economic situation more serious and more complicated.

**Table 2. Retail price indexes, 1986 - 1988**

(Previous year´s level = 100)

| | 1986 | 1987 | 1988 |
|---|---|---|---|
| Social market | 587.2 | 416.7 | 408.2 |
| State sector | 575.4 | 413.3 | 413.2 |
| Private sector | 682.3 | 429.2 | 394.8 |

Source: World Bank report on Vietnam, September 1989

**Table 3. Revenue and expenditure of the State budget**

(Billion Dong)

| | 1986 | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|---|
| Total revenue | 83.6 | 379.3 | 1617 | 3428 | 4460 |
| Total expenditure | 120.8 | 514.9 | 2710 | 5631 | 6712 |
| Deficit | 37.2 | 135.7 | 1093 | 2203 | 2252 |
| Budget deficit as % of total expenditure | 30.8 | 26.4 | 39.7 | 39.1 | 33.6 |
| Inflation rate (previous year´s level = 100) | 487.2 | 316.7 | 301.9 | 76.0 | 67.1 |

Source: World Bank report on Vietnam, September 1991

On the foreign field, since 1990 aids from Soviet Union and East Europe countries were sharply reduced making the international payment unbalanced thus increasing foreign deficit.

The banking system and credit organizations were also plunged into difficulties; bad debts were growing, credit organizations broke down. The money and credit system went on weakening. The prestige of the banks went decreasing due to the errors and shortcomings committed in the earlier years.

It was on that background that the State has promulgated on May 24, 1990 the 2 decrees relative to banking in order to continue its fundamental renovation, considering its renovation as a breakthrough in the economic renovation process from which banking renovation will be linked with other reforms in the national and foreign economies as well as with other production and business undertakings. All of that aimed at successfully building a market multisector socialist economy moving onward after the market· mechanism and under the State management.

The most noticeable content of the State Bank renovation is the renovation of monetary policy considered as strategic, fundamental starting point for renovating money and banking system. The banking system has practiced the policy called "monetary policy" but in reality is was a banknotes-issuing-policy and cash management in the economy. Many instruments and measures were misunderstood so we can say we had no monetary policy in its genuine meaning.

The monetary policy is an instrument of the State macro monetary management assumed by the Central Bank for its elaboration and execution aimed at stabilizing the value of the currency, and enhancing the economy. Such a policy not only regulates the volume of money supply (comprising cash inhand and account deposits) in a determined period for providing credit buying foreign currencies, extending advances to the state budget but also adjusts the volume of cash in circulation to the increase of nominal GNP which balances supply and demand of money (the monetary policy must control the causes of the increase or decrease of money supply).

The most comprehensive target of the monetary policy is accumulating and centralizing funds serving the strategic economic and social purposes, stimulating dynamics of various economic sectors for maximizing the utilization of labour and resources potentials of the economy aimed at boosting economic growth, national and personal incomes.

## 1.2. Objective and overview of study

**Objective:**

The main objectives of this study are summarized as follows:

(a) Focus on the mechanism implementation of the renovation process of monetary policy in Vietnam.

(b) Define the necessary conditions and the concrete solutions for carrying out effective monetary policy and to complete the monetary policy in the structure of Vietnam's economic policies.

**Overview of study**

The research paper consists of 5 chapters-with an overview of monetary circulation, policy mechanism and the monetary management before renovation period. The necessity of reform of these policies, in accordance with the new economic structure, is discussed in chapter 2. Chapter 3 examines the renovation of the monetary policy in order to stabilize the value of the currency and its role in developing the economy in Vietnam. The necessary conditions and concrete solutions, to ensure the effective implementation of monetary policy, is the focus of chapter 4. The study is concluded in chapter 5.

**1.3 Research methodology.**

For the purpose of this study, the methodology can be divided into two main parts:

(a) **Primary data sources**

Primary data for this research report were gathered through personal interviews with executives of the Central Bank and the other banks under study. Appointments were made well in advance of the data of interviews and questions asked were restricted to the prepared questionnaires since the executives were very busy. Questionnaires consisting of objective and subjective questions were prepared. Such questionnaires were handed to the persons concerned personally instead of by post. This is to ensure that good response could be achieved. The other statistical data were also obtained from the executives concerned.

(b) **Secondary data sources**

Information gathered in the paper is obtained mainly from secondary sources such as Economic seminar papers, newspaper abstracts, unpublished thesis and foreign publications.

## 1.4 Limitations

One of the major limitations in gathering the data for this research paper was the unavailability of a continuous time series macro and money variables. For example, monetary supply data is top secret, State Bank is not permitted to announce or release it to the public. The data of GNP is not based on system of national account (SNA) of the United Nations. However it is only roughly estimated, and thus, the foreign experts have warned that it was impossible to use these data for forecasting the other indicators as well as for purposes of comparison. Moreover the statistical system in Vietnam and particularly that of the banking system are very weak. Some of the necessary data can not be collected.