CHAPTER 2

MECHANISM OF MONETARY CIRCULATION MANAGEMENT BEFORE REFORM PERIOD: THE NECESSITY OF POLICIES REFORM IN ACCORDANCE WITH THE NEW ECONOMIC STRUCTURE

2.1. Overview characteristic of monetary circulation and policies management: pre-renovation period.

2.1.1. Monetary circulation situation before currency unification

After liberation of southern Vietnam, the main characteristics of money circulation in the period from 1976 to May, 1978 were as follows: Each part of the country had its own currency. In the North, it was banknotes issued by the State Bank, and in the South, it was banknotes issued after liberalization by National Bank of Temporary Revelational Government of Republic of Southern Vietnam.

These two kinds of banknotes were by nature signs of value, served as legal tender printed, issued and controlled by Central Government of Socialist Republic of Vietnam. But due to different economic conditions, it was necessary and suitable for each part to have its own suitable currency.

Because of that, a formal exchange rate of 1/0.66 between the two currencies was established. The basic for establishing this rate was: before 1975, the formal exchange rate of banknote circulating in the North, against the banknote issued by the former Saigon Government was 1/330. After liberalization as implementing the plan of withdrawing currency of former Saigon Government from circulation, issuing currency of Revolution Government with the purpose of strengthening purchasing power of new currency, the Government had established the exchange rate of 500/1 between old and new ones. Thus, the exchange rate of Northern currency against Southern was 330/500 = 0.66.

The money circulation situation in both parts of Vietnam was abnormal. In the North, the money circulation situation during many years was relatively stable. In the war time (1954-1975) and after reunification (1976-1990), the State Bank continuously had to issue money to cover budget deficit, while production and commodity circulation still remained weak. Bank credit, which bared the subsided character, was inefficient and depended mainly on issuing capital. Together with the others, these reasons contributed to a sharp increase in the amount of money in circulation. The amount of money (cash only) in circulation grew up by 35 per cent from 1976 to 1978, while the growth rate of national income was only 0.7 per cent. The price index was increased on average 40 per cent per year. The number of cash flow cycle through banks was down from 3.26 in 1976 to 2.86 in 1978. Inflation increased, banking system suffered lack of cash, and thus badly affecting social-economic condition.

The economy in Southern of Vietnam was based on market mechanism, and it depended mainly on foreign military and economic aid. Production activities were weak. Soon after liberalization (having no more foreign assistance), Southern economy could not get enough capital to support the economic reconstruction process. All the budget´s expenditure must be covered by newly issuing money. The consequence was an enormous increase in amount of money in circulation. Disparity between money and goods had led to hyperinflation, having negative effect on social-economic situation.

2.1.2. Money exchange in May 1978 and characteristics of monetary circulation practice after currency unification.

In April 1978, the politic bureau had granted decision No 08 NQ-TW on issuing new banknotes, withdrawing old ones from circulation in order to unify the currency. The purposes and requirements were:

(i) To build up an unified nation-wide money system and to stabilize monetary circulation in order to make it an efficient State management tool in the development of a planned economy.

(ii) By exchanging money, managing monetary circulation and other measures are to carry out income redistribution, to promote social reform restructure process in the South, and to complete socialist ownership in the North, aimed at a large scale socialist production in Vietnam.

(iii) To control over revenue and expenditure of different regions, enterprises and residences in order to efficiently manage monetary circulation, to meet the demand of the economy and to strengthen the effect of financial and economic management policies.

Implementing this decision, National Congres Acting committee and Government Board had the decision on currency unification and the cash limit to be exchanged immediately. The State Bank issued new banknotes for circulation over the whole country and withdrew from circulation all kinds of notes and coins circulated in the 2 parts of the country at the swap rate of one new dong to one Northern old dong and 0.8 Southern dong.

The process of exchanging money and issuing new notes have begun on May 3, 1978 and finished after 5 days. 95 per cent of previously issued amount have been exchanged, among this 48.7 per cent belonged to the North, and 51.3 per cent the South of Vietnam. The exchanged amount per capita was 50 Dong for North Vietnam and 53.3 Dong for the South, average exchanged amount per capita in the country was 53 Dong.

Comparing with the planned goals, the achievements were positive:

(i) A common monetary system and common market were established, creating conditions for setting up a common finance, credit and price system for the whole country, so that the Government could use these important tools to manage economic activities.

(ii) The Government took control over the structure of money allocation in public and economic sectors to assist it in managing money circulation.

Although a cash limit to be exchanged immediately have been fixed, but due to inefficient supervising measures, almost all the amount above this limit was allowed to be exchanged too. So the inevitable consequence is that the amount of money in circulation increased rapidly, having negative effect on the achieved result.

In fact, after the money swap, the money circulation practice became even more complicated due to an increase in budget deficit and total value of loan granted. At the same time, national income was not increased (even decreased in certain years), and this led to a sharp growth in price index. State Bank could not take control over cash income and expenditure management. Because of that, money-commodity relation continued to develop adversely.

2.1.3. Monetary mechanism before renovation period

"Monetary policy of Vietnam nowadays is as follow: (i) mainly use bank credits in order to promote the development" of production, stimulate effective renovation, (ii) promote the process of social workforce allocation, and explore available potential labour, land, jobs, premises, (iii)

create most favorable conditions for changing economic activities based on centrally subsidized bureaucratic mechanism of management into centralized democratic economy with method of economic accounting and socialist business, (iv) help the Government to rearrange production and capital construction effectively, (v) control the production process and promote the course of socialist reform, (vi) establish the socialist relations in terms of production, balance gradually the budget and cash. The policy is aimed at high appreciation of effective money utilization so as to implement socialist reform and build socialism effectively".
(Cite People's paper October 27, 1985)

In conformity with the planned economic mechanism of management, the mechanism of money management and regulation of money circulation is implemented in the following way:

(a) State Bank acts as cash, credit and payment centre in the national economy by printing and issuing of currency and money circulation according to the planned regulation on monetary circulation.

(b) Mainly use some instruments as general cash plan, general credit plan, statement on money collection and expenditure, carry out cash management regime applicable to all enterprises, organizations, state-owned institutions, units of army forces and cooperatives, as well as control over the use of salary funds of the State-owned enterprises.

In the centrally planned management mechanism, the general cash plan of State Bank of Vietnam is considered as the top instrument used for implementing currency, managing and regulating money circulation in accordance with the requirements of the monetary policy.

However, in the process of implementation, the degradation of cash plan changed this plan into the basis for estimates of planned targets of currency issuing to be approved by the Government. The State Bank of Vietnam allocated first and then the State Bank of Vietnam branches distributed among subordinated units. So lastly the estimated targets became the plan on cash distribution to the all owners who had deposits at the banks according to liquidity of the banks.

This led to the common situation that in the plan of the branches submitted to State Bank of Vietnam, the estimated needs for cash are sometimes falsified and they are more than the actual needs so as to avoid cutting down from SBV (State Bank of Vietnam). Thus the banks at lower level often set up falsified plans with higher expenditures and lower revenue to prevent cutting down from SBV. But the Government required the banks to try the best to increase revenue and reduce expenditure. At the same time, the governemnt approved the surplus figured monthly and weekly in order to limit cash issuing: whereas the increase of budget surplus and subsidized credit were kept on with galloping inflation, and money devaluation. Thus, the needs for cash increase rapidly, which made the banking system fall in the situation with lack of cash. Attention must be paid to the fact that in the process of drafting and approving cash plan there was a common outcome occurring regularly. That is the planning institution often sets up higher targeted figures on expenditure or vice versa lower figures on income in order to avoid downsizing of figures. Nodally approved institutions often set up higher targets. However when the targets were not reached, the economy bears all the consequences of a short fall.

General credit plan by SBV is determined as part of the general planning system of the national economy and it is also considered as an instrument used for regulating money circulation. The tasks of the system are as follows:

(a) Carrying out the mechanism of money issuing through credit channels and determining the instruments used for absorbing money from circulation when necessary.

(b) Implementing and expanding the state credit policy and setting up restrictions on financial allocation. SBV must ensure efficient capital reserves to meet the demands of the state-owned enterprises, state entities, primarily the capital demand for production and purchase of goods. The credit volumes must be suitable with the value of materials or goods to be guaranteed.

In the course of implementation, credit plan has played very positive role.

(a) It has met the requirements of the centrally planned subsidized economic mechanism. Thus it also has met almost the capital needs for production, circulation and distribution in the state economic sector and collective sector based on the state plan enhancing the state budget effectively.

(b) Through the implementation of credit policy and active issuance of money for circulation. Money is then used as an instrument to explore all the potential materials and workforce conditions created for socialist reform.

(c) Used credit lines to improve money control and strengthen the economic management regime.

However it had some main disadvantages:

(i) The credit plan as an instrument for implementing money policy is aimed at mobilizing of capital is not paid enough attention to as it used money issued widely for credit including credit for investment on capital construction, to assist the budget or to subsidize widely. So it did not play the role of regulating monetary circulation. However it became the cause of inflation.

(ii) Credit based on plan in the subsidized mechanism itself created false demand for capital. Many banks have the tasks to provide timely and sufficient capital with low lending rates, they did not care about capital mobilization. The credit demand is implemented by account transfer, but lending one institution creates deposits of others thus the bank have to meet the demand on cash expenditure. As a result the banks are unable to control the credit balance that increased far too quickly than the speed of economic growth. So credit plan becomes an instrument that hinder money-goods relationship and violate strongly the money circulation law.

Cash management is an important step in the mechanism of money circulation. In conformity with the state regulations, all the organizations, and institutions have to open deposit account with the banks. Money received or paid must be entered into the accounts.

Cash management activities have been implemented since 1957 and were implemented effectively from 1957-1965 as follows:

(i) Mobilized various cash resources and cash transfer through the bank so that the Government could manage the money, and actively regulate the demand for cash according to the plan so as to oversee the production, purchase of goods and other economic development needs.

(ii) Promoted cashless payments through the banks, and this saved much cash in circulation.

During the war, the country began to spend more and more money on the war against America. The principles and rules of socialist economic management were loosened and the effectiveness of cash management was also reduced particularly in the period of increasing inflation.

However, in the condition of low economic development production did not satisfy the demand consumption, wages were some sort of minimum subsidy, goods distributed were under the minimum level, poor economic management and the control over wages and salaries were ineffective. Thus this led to many big difficult economic problems.

In short, monetary circulation before the renovation reflected a biting economic inbalance as well as the weak and ineffective monetary policy and monetary circulation control mechanism.

An administrative monetary policy and commanding management mechanism of monetary circulation were used as instruments serving economic and politic targets of the Party and the Government for our socialist construction. They are the highest targets controlling the process of the implementation of monetary policy and management. However, the disconnection between monetary policy-management and economic laws had rendered all monetary instruments ineffective and caused a great harm to economic development.

2.2. Requirement for monetary policy renovation and implementation of monetary policy in Vietnam.

2.2.1. Requirement for the establishment of monetary policy, and the formation of renovation in the establishment and implementation of monetary policy.

In the renovation of economic management mechanism in Vietnam, the fourth Congress of the Party confirmed: "*Renovation means the elimination of concentration, cumbersome bureaucracy, subsidy and the establishment of new mechanism corresponding to objective laws and the current development of the country*". The document of the Congress showed: "*The movement from tiny production to large-scale production in our country is a process of replacement of self-sufficient production by an market-oriented one. We manage by planning. Goods production with the characteristics of the transitional period. An efficient utilization of goods-money relationship in economic planning is an objective necessity... Goods-money relationship requires the coincidence of production and the markets. We have to compare the costs to efficiency. Every organization and economic enterprise has to make profits for its own re-production and expansion*". (The document of the Fourth Party's Congress printed in Communist Magazine January, 1987

The development of a multisector goods economy, movement following market mechanism with Government management, efficient utilization of money-goods relationship, implementation of cost accounting, independent production, quality and profits used as the standard appreciation of efficiency in production and business etc are objective economic foundations and necessary requirements for the renovation in banking. By doing that, money can assume an inherent function, that is an efficient instrument in organizing and managing the economy.

One of the basic characteristics of a market economy is the power of money, money is "all powerful" and it forces people have quick reactions. Money shortage in the market will lead to price reduction. As a consequence, production and circulation will be hindered , interest rates increase and circulation will be in a mess. Ensuring the balance of goods and money, stabilizing the money value are ideal conditions for economic development. Therefore, in economic innovation, the renewal of monetary policy is very important. A sound and efficient monetary policy will stabilize the value of money and spur economic development. The document of the Sixth Congress of the Party also focused: "Fiscal and monetary policies are very important and necessary in the implementing of cost accounting business, in conquering inflation and stabilizing the purchasing power of money" (The document of the Congress printed in the Communist Magazine January, 1987, page 50).

In fact, the Government for years did not have a meaning for fiscal and monetary policy. The objective necessity of renovation in monetary policy and management were realized only when we began implementing the Government´s policy on basic renewal of banking activities.

In the light of the resolution of the Sixth Congress and other resolutions of the Board of the Central Party, we gradually get to know the faction of money and scientific methods in controlling monetary circulation in a market-oriented economy and establishing a monetary policy suitable to our current condition. Therefore step by step we have conquered inflation and stabilized the purchasing power of money.

In the early years of innovation the economy was in a bitter recession and rocket hyperinflation rate. *"The banking sector in cooperation with financing and other economic sectors had an urgent duty to balance the quantity of money in circulation, stabilize the purchasing power of money and supply the money demanded in production expansion and goods circulation"* (The document of the 6th Congress printed the Communist Magazine January, 1987, page 50). Being aware of its own functions and duty, restructuring its system, establishing a two-tier banking system and the State Bank has established a system of monetary policy and a management mechanism of monetary credit and payment activities in order to reduce inflation.

On the basic analysis of the money supply and demand in a market economy with serious inbalance of money supply and demand in the past, we began to build up a monetary policy in accordance with the new economic ideas:

(i) Having to determine the quantity of money supplied, it is necessary that payments consist of: (a) Money circulated outside the banks and, (b) Entries in books which express the balance of deposits for settlement in the banking system. They are the two main components, (c) Time deposits at banks and other financial assets which can be easily liquidized.

(ii) In determining the quantity money supplied (increase or decrease) every year, we have to consider the following determinants: (a) Nominal GDP, (b) Inflation and (c) Velocity of money circulated.

(iii) Controlling the root of the quantity money supplied, not only running after the consequences. It means we have to control the origin of money creation: Credit, advances to the budget and money supply for foreign reserves. In our current condition we mainly control the first two origins.

(iv) A market economy governed by the state requires a monetary policy which can be used to control the quantity of money supplied and monetary circulation by the price level, ensuring the purchasing power of the currency. In our current condition, we should apply a tight monetary policy in the first step, making foundation for the State Bank to act as the survivor, the lender of last resort and being active in supplying and controlling money in circulation.

(v) The State Bank has the duty to establish and organize the implementation of monetary policy, utilizes the monetary policy as a main instrument in macro management of the State Bank.

2.2.2. The process of establishment and implementation of monetary policy in Vietnam.

Since 1990s, by implementing the two banking degrees, the banking system has been reorganized and become a two-tier banking system:

(a) The State Bank does the work of a Central Bank, it has duty to build up and carry out monetary policy and acts as the banker of other banks.

(b) Credit institutions which consists of commercial banks and other credit institutions carry out currency trade for profits on the basis of "borrowing for lending". They are either state-owned, shareholder, cooperative or foreign bank owned.

The process of implementation of the Banking Decree was a process of overall and basic renovation of banking activities, together with the establishment of a new organization model, from 1990 to 1991. The State Bank has focused on the establishment of a new policy and mechanism about banking profession. The State Bank's control instruments are interest rates, credit, foreign exchange, precious metal, obligatory capital reserves etc. However, we *"have not established a monetary policy that can be used as a basic background for banking activities, and have not promulgated a mechanism for controlling monetary circulation"*. (From the article of Governor **Cao Si Kiem** in Banking Time, number 1, 1992). It shows that building up a monetary policy and mechanism for monetary circulation management is a very complicated duty.

At the beginning of 1992 the Ministers Council drafted out the number one duty: *"Control and decrease inflation, stabilize financing and monetary activities, improve the salary system"*. In order to complete that duty as well as other duties to the banks as ordered by the Council of Ministers, the State Bank laid out three main tasks in 1992, in which the first task was: *"Reviewing the Banking Decree, collecting practical experience in order to use for the next step of renewal. In the spirit of the resolution of the 7th Congress of the Party and in accordance with the existing conditions in Vietnam, monetary policy is established as the basic foundation for the innovation in 1992 and the years thereafter that"*, this is the period that we organize and implement monetary policy according to articles 13 and 14 of the Banking Decree.

While waiting for the establishment of a suitable monetary policy for the condition of Vietnam, the State Bank submitted to the Government *"The basic contents of the mechanism for money supply in banking activities, and clarified quantity of money needed to be supplied in 1992"*. Therefore, the Government could make a decision to allow the banks to act as an important part of the new monetary policy. In short, the contents consist of:

(a) The mechanism for the supply and moderation of money in banking activities:

(i) The State Bank and commercial banks should be ready to fulfil the withdrawal orders of the account holders, either in case or by transfer denting on their requirements.

(ii) Every year, with the economic development, the State Bank in coordination with other Government´s general sectors, clarify the extra amount of money needed to supply in the next fiscal year, depending on the following factors: economic growth rate, inflation rate passed by the Parliament and the velocity of money in the fiscal year.

(iii) The amount of money increased according to the consideration and approved by the Council of Ministers is the planning target. However, daily and monthly implementation of the plan will be executed by the Governor of the State Bank in accordance to the real money supply and demand condition, through which we can pool in or withdraw the money in circulation

(iv) The necessary increase in quantity of money consist of cash and demand deposits that is used for : increase foreign reserves, offset the budget deficit when there is no way to reduce the budget deficit. The bank will make loans to finance the budget, and what is left will be the credits to the economy depending on the economic growth rate.

(b) Define the necessary increase in quantity of money in 1992 and the supply and moderation of money in the banking system, the State Bank developed on :

The economic growth rate target approved by the Parliament was 4.5 per cent, inflation rate controlled from 30 to 40 per cent in 1992, and the velocity of money in circulation increased by 0.3 in comparison to 1991. Based on the above figures, the perceived socio-economic development orientation passed by the Parliament was *"Continue to control and decrease inflation, try to stabilize the currency"* and *"renovate the mechanism for monetary circulation, credit and banking in accordance with a market mechanism"*. The State Bank executed banking activities by targets and instruments of monetary policy.

After a year of banking activities operated by monetary policy, it has brought about many good results and experience: Main instruments applied in the last period were the methods of controlling increase in high powered money, along with the stop of issuing money to cover the budget deficit, credits extended to the economy in accordance with the growth rate of production, close control of the credits of the State Bank in credit institutions and implementation of a suitable interest rate policy in accordance with the supply and demand for money. The State Bank actively intervened in the foreign exchange market and gold market in order to stabilized the level of price. The State Bank also simultaneously accomplished payment guidelines through the banking system and ensured the money supply demanded in the economy. By that way the State Bank had a great contribution to the control and decrease of inflation, to the improvement of credit mechanism, and ensurement of capital needed in production.

However, the control of credit expansion was not sensitive or tight. The State Bank did not actually and effectively act as the lender of last resort by the method of re-credit. Besides the credits of banks, there existed the credits of the Treasury which were out of control the monetary policy. One of the most new important instruments is the minimum level of statutory reserve. This instrument in fact, did not act as an instrument of regulation but as a security payment ability. In general, the instruments of monetary policy were limited in scale and financial market effectiveness was monotonous. The necessary conditions for the implementation of monetary policy were limited.