CHAPTER 3

RENOVATION AND PERFECTION OF THE MONETARY POLICY: STABILIZING THE VALUE OF THE CURRENCY AND DEVELOPING THE ECONOMY

3.1. Some principle issues on making and implementing monetary policy.

3.1.1. Aims of monetary policy should be subjected to macroeconomic goals, but the basic aim is to stabilize the money value, and to create a firm foundation for progressive economic development and to improve the living standard.

3.1.2. The monetary policy should ensure that supply of money is enough to meet the demand of goods, and goods circulation. They also ought to control original supply of money in order to maintain the suitable relation between money and goods in each development period.

In cases where there is a high rate of inflation in the economy (more than one digit) it is necessary to apply the tight monetary policy that limits the money supply and reduces the demand of money, in order to lower the rate of inflation to the planned level and to restore money value.

With a reasonable rate of inflation, the monetary policy should be active in order to regulate the inflation rate level. When economic growth rate needs to be increased, or more jobs need to be created or unemployment needs to be reduced, we could actively increase money supply in order to stimulate investment and productive development.

3.1.3. Money supply quantity in circulation is money supply in media of payment including cash in circulation and deposit presented to be the balance of deposit account of business bank system in both Vietnam Dong (VND) and foreign currency to be converted into VND.

The deposit quantity is a part of money supply because:

(i) The deposit on payment account of banking system is mainly used to do settlement by cheque and other media of transfer so that the written money is created instead of cash use in goods selling-buying processes and services settlement.

(ii) All kinds of deposit are in the forms of storing value in money, i.e, when due or customer wish to withdraw their deposit, banks must be ready to answer their demand in cash or written money, no matter what kind, money should be medium of payment.

3.1.4. The needed supplied amount of money in circulation is a variable that is directly proportional to nominal gross national product (GNP) and is inversely proportional to money circulation rate. This concept means:

(i) The increasing or decreasing amount of goods and services supplied determines the increasing or decreasing supplied amount of money in the same direction at the same time.

(ii) The increasing or decreasing price level of goods and services determines the increasing or decreasing supply of money in the same direction at the same time.

(iii) The fast or slow velocity of money circulation determines the decreasing or increasing supplied money in negative direction at the same time.

3.1.5. The changing amount of supplied money can also be affected by following factors:

(i) The supplied money will be increased when the money base increases and vice versa.

(ii) The supplied money will be increased when money rate (the rate between cash in public and their deposit balance at bank) decreases and vice versa.

(iii) The supplied money will be increased when the reserve rate (the rate between cash reserve and public deposit balance in business banks) decreases.

3.1.6. It is necessary to classify and specify the components of money supply to different factors in order to control and regulate it easily.

In the present circumstances of our country, other media used instead of money as medium of payment are still not developed. The components of money supply include:

(a) The cash in circulation outside the banks is considered as a component that has the ability to make payments absolutely fast. Its origin is from income and existed in the form of reserve funds in society (including enterprises, economic-social organizations, households, individuals). The motives of cash reserve are:

(i) Money demand for transaction, money is used in daily consumption of household, and enterprises, which is used for material expenses, salary, business, etc.

(ii) Savings for future consumption and property purchase.

(iii) Reserve for investment to make profit.

High or low reserve of cash directly affects the price of goods and services, in turn it is also directly affected by interest rate. So cash component outside the bank becomes a first object to be regulated and controlled by monetary policy.

(b) Payment deposit of enterprises, economic organizations and, household business in commercial bank system is used to make payment for goods purchase and service the running of business settlement. It is mainly carried out through the banks in written money and small amount in cash.

(c) Demand deposits of organizations, enterprises and public do not bear the characters of payment deposit. Banks are asked to be ready to pay the depositors at any time, mostly in cash and other in written money. This component is also sensitive and easy to make payment.

However, at present in Vietnam, the demand deposits mainly consists of deposits of the public, but the remainder is payment deposit. So most deposits have to be made in cash, as the result it considerably limits the ability of banking system to create money.

The points disclosed between payment deposit and demand deposits are that they have the same characteristics, that they are demand deposit, and ready to enter in circulation at anytime when payment demand appears. But the difference is that the payment deposit create the conditions for banks directly to increase it credit multiple-means by itself to increase quantity of money supply while demand deposit does not bear the character of payment deposit. Demand deposits only gives bank limited favours, unless the banking system has attracted most of economic transactions through the banks. This should be taken into account when managing the rate of legal reserve.

Three components of money: (i) The cash in circulation outside the banks; (ii) Payment deposit known as written money; (iii) Demand deposits not only plays the role of written money (although still limited) but also easily converted into cash. The two last components have similar ability in making payment and always change into each other.

Three component of money are considered to be together as one component with the same characters: Transaction money plus money component with the fastest and most sensitive ability for payment is known as M1, the main object of monetary policy.

(d) The time deposit in short-term is the deposit with the term shorter than 12 months that has characters of profitable reserve funds with "the hidden buying power". It only appears in circulation when due, but when money is withdrawn from the bank to enter exchange, the amount of money is increased in comparison with the original amount. The widened amount is directly proportionate to interest rate and deposit term. In comparison with the demand deposit, the fast and sensitive characters of payment are slowed down which depends on the deposit term.

In Vietnam, most time deposits are deposits of the public and must be paid out in cash. So when defining time-deposit as a part money supply, following things should be mentioned:

(a) The fast and sensitive character of payment is slowed down, and depending on deposit term. The result of reaction would be a decrease of monetary base in short term.

(b) When deposits are due, amount of withdrawn money is bigger than deposited money. Moreover if most of the depositors are asked to withdraw in cash the monetary base could be increased.

For that reason, in money statistics the time deposit is an isolated part. This component plus M1 component become a bigger component and defined as money in broad meaning known as M2. In fact only M2 is given more attention in Vietnam.

3.1.7. The issues of management mechanism and monetary policy realization.

As the mode of handling our economy determined by the seventh conference of the party is *"Market mechanism is controlled by state with law, plan, policy and other tools"* (the document of Seventh Conference of the Party, page 55) and depending on functions and tasks of State Bank as determined by decree of State Bank of Vietnam: *"State Bank is the organ of minister board (now known as government), has functions of State management on money, credit, banking activities inside the country to stabilize money value, is a unique organ to issue the currency of socialist republic of Vietnam"*.

(a) Economy management-money and monetary policy realization are carried out by the way of laying down the orientation policy, determining basic goals presented by economic indexes of long-term plans as well as short-term plans. State Bank is empowered to make and realize monetary policy.

In policy orientation, based on demand of social-economic development plan and given situation of each period, government will lay down policy that is executed by State Bank to answer the questions of what monetary policy should be applied? (tight policy, loose policy, floating policy). Depending on that basis, State Bank makes suitable monetary policy and creates the measures to submit to Government for approval.

Based on Economic targets the goals of policy in each period is presented and only some main targets are managed by Government:

(i) The rate of inflation is permitted in each period of plan.

(ii) National reserve level of foreign exchange.

(iii) Monetary rate supplied increases or decreases in comparison with previous period according to reducing or increasing indexes of nominal gross national product, permitted price level, planned reserve of foreign exchange.

Annually, 10 to 15 days prior to the plan year, the Government sends those targets to State Bank and requires State Bank to plan the money supply during plan year. State Bank must submit it to Government in the first 10 days of January for approval.

The Government will only ratify the total increased amount of money supply and send as soon as possible to the State Bank in order to regulate the supply as required by monetary policy of plan year.

(b) State Bank is given tasks to build and organize monetary policy realization and is responsible for the result of the aimed realization of monetary policy. Therefore, the Government gives State Bank a completely active right to issue money in limitation granted at the beginning of the year and to apply measures to control and regulate the money supply in order to gain the goals of monetary policy.

(c) In order to make and implement monetary policy in high effectiveness, Government should enact clear legal documents on:

(i) Leading and managing mechanism of Government on State Bank in making and realizing monetary policy.

(ii) The tasks and powers of State Bank in making and realizing monetary policy.

(iii) The relation between State Bank and other ministries branches in other local regions in carrying out the tasks of State Bank.

(d) The determination of the total necessary increased in the amount of money supply is considered to be among the basic economic targets approved by Parliament and among foreign currency reserve targets determined by the Government. On it side State Bank has to calculate the velocity of money circulation.

Under the present circumstances of our country, the determination of velocity of money circulation is too complicated, and in the world many scientists have confirmed that the rate of money circulation is relatively a stable variable. Therefore, in calculating and determining the necessary increased amount of money supply, we temporarily, consider the velocity of money circulation as a constant variable in comparison with previous year and apply the convention formula to calculate:

$$\mathbf{A = \{ B * (a + b) + D \}}$$

In which:

A : The necessarily increased amount of money supply in plan year.

B : The factual money supply at the beginning of plan period.

D : The necessarily increased reserve level of foreign exchange as plan.

a : The rate of economic growth - nominal GNP

b : Controlled rate of inflation

3.2. The aims of monetary policy.

"The overall objective of the Strategy up to the year 2000 are: To get out of the crisis, stabilize the socio-economic situation, strive to overcome the state of being a poor and underdeveloped country, improve the livelihood of the people, consolidate national defence and security, create conditions for the country to faster develop into the 21st century. The Gross Domestic Product (GNP) by the year

2000 will be doubled against 1990" (Economic Reform Policy in Vietnam: Aims, Instruments, Results; Norbert von Hofmann Friedrich-Ebert-Stiftung; Hanoi. November 1993)(see Table 4)

Table 4: The Strategy sets the following economic targets for the year 2000

		1991-1995	1996-2000	1991-2000
GNP growth rate	%	6 - 8	8.5	8
Agricultural output	%	4.1 - 4.5	4.0 - 4.5	4.2
Industrial output	%	10 - 11	14 - 15	12.5
Export	billion US$	15	30	45
Consumption	%	3.5 - 4.1	5.0 - 6.0	5.0
Accumulation	%	10 - 15	16 - 20	14 - 18
Investment	billion US$	10.5	34.5	45

As the aims of economic development and stability are up to the year 2000, thus the aims of monetary policy should also be classified: in long-term goals of up to the year 2000 and short-term goals of each year for that period.

3.2.1. The aims up to year 2000.

(a) The first aims are to push back and control inflation in order to establish a stable foundation of money and to create solid basis for economic development. The concrete target is to draw back inflation and keep it at 5 per cent to 7 per cent in the year 2000, and to determine an actively controllable rate of inflation. This rate is then used as a stimulating substance to develop economy toward the aims.

(b) Pushing up economic growth to gain the figure of 10 per cent annually on average.

(c) Creating more jobs for working people in order to eradicate hunger and poverty.

(d) Reducing the deficit of balance of payment, stabilizing exchange rate and bank note.

3.2.2. The aims for each year.

The short term aims for each year is determined by and to be based on basic social-economic goals of plan year approved by the Parliament. It is also relayed to the State Bank who bases on it to determine the goals of monetary policy in the year. They include:

(i) The value of nominal GNP of plan year and reducing or increasing rate in comparison with previous year.

(ii) The permitted controlled rate of inflation in plan year.

(iii) The reducing or increasing reserve level of foreign exchange in comparison with previous year.

These are the concertized targets and objects to be regulated by monetary policy in plan year.

On the bank's side, the aims of first place are pushing back and controlling inflation whenever inflation rate level still fluctuates at two digits level (more than 10 per cent a year). If inflation rate level is about one digit (smaller than 10 per cent) level at which State Bank could actively control, then the first place aims of stimulating economic growth will be achievable.

3.3. The content of monetary policy.

The content of monetary policy includes:

3.3.1. The policy on money supply and money supply management.

This policy aims to satisfy the demands of media of payment in the economy and to establish and maintain the balanced relation between aggregate supply and aggregate demand of money.

In Vietnam, in the coming years, in order to push back and control inflation rate based on annual target, it is necessary to apply the policy of money supply limitation and the policy of money demand deduction at the same time. These are:

(a) State budget deficit is not covered by money issue. Thus budget implementation will cause positive interactions: push up finance ministry to maximize all collection sources, be against collection failures and embezzlement, cut down expenses and strengthen the issue of bonds when funds are borrowed the from public. This is considered as a good method to cover state budget deficit. All the above measures directly limit money supply and money demand in economy.

(b) The money issue mainly focuses on economic development and it is carried out by lending to credit institutions. Since economic growth determines the increased amount of money, so at the present period it is necessary to apply the principle of money-goods relation: to issue 1 per cent increase of the money supply when there is a 1 per cent increase of GNP. According to modern monetary theory, it is proven that if there is a 1 per cent increase in income, 1.8 per cent increase of money demand is needed. So when the 1/1 rate principle of the money supply is applied it means 0.8 per cent of the necessarily increased amount of money supply is short. The 1/1 rate principle of money supply will cause deflation according to mentioned theory, when the relation between money and goods become balanced. Inflation rate will be pushed back to maximum. Therefore, money supply rate should be higher.

The money issue, carried out by ways of lending to credit institutions, should be focused on pushing back and controlling inflation. So, it is necessary to apply the tight credit policy whose aims are (i) determining the necessary amount for economic development, within credit limitation, (ii) deciding the rest according to the rates of equities of credit institutions that need to borrow funds,

(iii) applying high interest rate of wholesale, and (iv) introducing conditions to ensure strict credit. This policy carried out will cause compound action on both sides. Firstly, it forces credit institution themselves to run their funds by increasing funds mobilization, and strengthening funds collection to meet their lending demand instead of borrowing from State Bank. Secondly, when credit institutions use the interest rate of borrowing in the market, then the attracted funds in the bank decrease market money demand because credit institutions lend out at high mobilizing rate. So the rates of the funds-borrowing enterprises are pushed up to exploit effectively their abilities to reduce funds borrowing demand, therefore, money demand is reduced.

So the tightness of credit is limiting money to enter circulation, and also, through reducing money demand, it speeds up money circulation rate in the market. Inflation, therefore is directly push back and controlled. However when inflation rate decreases to an acceptable level, this policy will obstruct economic development. In this case the loose active credit policy should be applied to stimulate economic growth.

(c) In the economy where inflation is still rampant, price level will be inversely proportional to money value. So the number of money unit used to buy one unit goods, goes up also. Spare quantity of money will be disappeared by itself in this process if State Bank does not issue more money to fill this space.

In Vietnam, inflation rate is still high, after balancing the economic targets annually. Government determines the inflation rate - striving targets to reduce inflation as required. So it is expected to increase the money supply level corresponding to controlling inflation rate in order to cover the deficit quantity caused by money value loss.

(d) Establishing and fostering reserve of foreign exchange is one of the important requirement of monetary policy. This could only be gained when there is a surplus on balance of payment, and mainly on balance of trade. However in the situation of Vietnam, the balance of payment is always in deficit state. This means we are always in shortage of money to settle the debts. But in fact, over the past few years the large inflow of foreign currencies was out of State control and came from non-trading (estimated at about USD 1 billion). One part of the large inflow is attracted into bank accounts. This plays the role of profit making tools as well as acting as hidden buying power. It could also be withdrawn and changed into domestic currency or foreign currencies. The other part is the "underground circulation" in the domestic market. It lays a role as means of reserve, and medium of exchange instead of using domestic currency. It is also illegally replacing domestic currency.

In fact, it is required that State should take advantage of market mechanism in order to attract most of those foreign currencies and put them in the national reserve funds. Those amounts of foreign currency can also be replaced by domestic currency. So in money supply for the years 1991 to 1995 or to 2000, a given amount of money increase for each year should be put in reserves as foreign exchange in the State plan.

3.3.2. The credit policy for economy.

It is required that the tight credit policy should be applied simultaneously with the aims of monetary policy. This policy needs to be maintained as long as the inflation rate decreases to 2 digits. Main contents of the policy are as following:

(a) Commercial banks and credit institutions are the main organs who run credit business under the law and other policy of the Government. They are sovereign in business for existence and development. They also act by themselves to create capital sources for widening the lending activities and to meet the demand of economic development by way of borrowing for lending. They also are required to maintain the solvency in order to keep the customers´ trust.

No matter what economic sectors, all credit amount between banks and lenders or between banks and borrowers, are run under market mechanism. In this case both sides agree with each other and no pressure is exerted on one over other.

If the investment directions of Government are the economic structure, industries will source the Government capital and will be given privileged interest rate. In this case business bank should be ready to fulfil the Government policy and directly receive that capital to invest in planned area. The service is done with the Government.

(b) State Bank acts as a manager and lender of last resort for credit institutions.

State Bank uses its own tools firmly to control development rate and quantity of credit, and to regulate credit development rate so as to be suitable with economic growth, and to prevent inflation caused by credit abused.

With refunds policy, State Bank plays a role of lender of last resort for credit institutions. Funds lending activities are carried out in credit limitation. The total amount is decided in accordance with the economic structure. But the total amount cannot exceed the maximum permitted amount in the economy.

The determination of credit limitation is done in the following way: Priority limitation is determined by per cent rate increase in comparison with debit balance of previous year. The remainder is decided according to equity rate of each credit institution. That means:

$$\text{Credit limitation each credit institution} = \frac{\text{Its equity} * \text{Total credit limitation}}{\text{Total equity of credit institution to whom credit limitation is granted}}$$

The refunds activity of State Bank is done mainly in the mode of relending and lending with short-term securities guaranteed. Those securities are easily converted into cash.

State Bank forms and regulates interbank money market where business banks lend each other. They themselves also interact in money supply and demand. In this market State Bank plays the role of lender of last resort only.

3.3.3. Policy on foreign exchange.

In monetary policy, it is required that foreign exchange should be synchronously managed and monopolized by the Government. Foreign currencies are not permitted to circulate in Vietnam territory. All people living in Vietnam are not permitted to use foreign currency except Vietnam Dong. Bank note as well as coin issued by State Bank are uniquely legal currency and unlimited means of payment in Vietnam territory.

All activities of export and import, foreign exchange buying, foreign exchange selling, foreign exchange storing, foreign exchange ownership transferring should be under the control of foreign exchange management policy. Only by this way foreign currency sources could be gathered in reserve funds of the State. This ensures that State Bank would actively and effectively use foreign currency for economic development and in regulating money circulation.

For the case of Vietnam, there has been a relatively large amount of foreign currencies in circulation of which most of them are USD in illegal circulation. They are "underground circulation" (Black market) whereby they invade the domestic currency´s room. Bad feelings are generated in the public and this USD as the means of value store and for selling and buying expensive imported goods. If this situation continues, illegal goods will be, of course, stimulated, USD inflow will come from the non-trading source, and so they will be out of Government control. As a result the field of domestic currency circulation is narrowed. USD is preferred as a store as well as consumption purposes. Thus, the role of domestic currency is lowered. This process will cause unforeseen losses.

Therefore, the policy on foreign exchange management should be focused by overcoming the above problems. The policy is carried out in the early years from 1993-1995. The main points are as following:

(i) Strict management policy should be used. Foreign currency sources is gathered in the hands of the State instead of the loose policy that permits foreign currency to scatter in the public.

(ii) The exchange market should be organized immediately in Vietnam (its activities include international and domestic transactions) in order to stabilize the exchange rate, and to run foreign exchange business.

(iii) Together with policy management we should establish money transferring shops at harbour mouths in economic and tourist centers, in big cities especially in Hanoi capital, Ho Chi Minh city, Hai Phong city, Da Nang city, and Baria-VungTau region. All these centers are under the direct control of State Bank or bank who are permitted to transact.

(iv) State Bank determines and announce the exchange rate between VND and foreign currencies synchronously at defined times each day including buying and selling rates. State Bank also determines the price frame that are the directives to handle exchange markets and activities of money transferring stores.

3.3.4. State budget and monetary policy.

(a) The monetary policy as well as other policy on State budget collection and expenses are the tools for implementing macroeconomic aims, for they support each other. Therefore, State Bank should play a positive role to contribute to State budget planning. It does it together with finance ministry to calculate and estimate the necessary amount that State budget needs to borrow from the bank in the fiscal year and to submit to the Government for approval.

(b) In general, the money issue to cover the State budget deficits is not permitted as long as the aim of monetary policy is controlling inflation. The State Bank does not issue money to cover the State budget deficit, it only gives State budget a determined limited advance in a form of short-term borrowing, and to be guaranteed with treasury bonds, in case State budget temporarily does not catch up State budget collection. Normally the advance must be repaid in the fiscal year.

(c) The total amount, which State budget needs to borrow, is determined in credit limitation for State budget and also in domestic credit limitation. This means credit limitation is high for State budget if credit limitation is low for economy and vice-versa, while total credit limitation is unchanged inside the country as planed.

3.4. The tools of monetary policy.

Monetary policy is used in order to control and regulate the money supply, and to push back and limit inflation and to build a stable monetary foundation for economic development. It is necessary to use actively the main following tools.

3.4.1. Determining credit limitation, using credit limitation to control and to supervise the money supply.

The main concern is the increased of the money supply. Therefore, in Vietnam where finance market is in the forming and developing stage, the application of this tool is suitable and necessary. Firstly it permits us to actively control the necessarily increased amount of money to be suitable to economic development in plan year and also to limit and to regulate the increased amount of credit in general. In order to use effectively this tool it is needed to:

(i) Calculate and determine the total money supply of which there is a part to meet the demand of the increase of GNP. The price increase is taken into account in plan year and is used as the basis to define total domestic credit limitation.

(ii) The credit limitation is apportioned in the economy as well as to set the credit limitation for State budget in a strict way.

(iii) Manage the credit limitation to be suitable to the pace of the economic situation, inflation and money growth in each quarter of the plan year.

The increased amount of credit limitation is determined by the total increased of money supply in plan year. It is the result of total money amount minus the demand of the increased amount of foreign currency reserve.

The increased amount of credit limitation is divided into two parts: Most of them are used to provide credit to economy, the remainder is the advance for State budget (when needed).

The credit limitation for economy is apportioned to commercial banks for short-term only. Apportion principle is as follows:

Firstly, economic industries which need giving priority is given an amount and this is referred to as privileged credit. This part is calculated in per cent in comparison with normal credit limitation. The remainder is apportioned according to equity rate of each bank, and called normal credit limitation. That is :

$$\text{Privileged credit limitation} = \text{Normal credit limitation} + \text{Normal credit limitation} * \text{Privileged rate}$$

$$\text{Normal credit limitation} = \frac{\text{Total credit limitation} - \text{Privileged credit limitation}}{\text{Total equities of bank to whom credit limitation given}} * \text{Equity level of bank to whom credit limitation given}$$

Secondly, credit limitation is apportioned according to the increasing or deceasing rate of credit limitation as defined above in comparison with average the real debit balance level of 90 days of fourth quarter of previous year. The limitation is also apportioned for each quarter of the year, and depending on crop season.

Table 5a: For example of apportioning for Bank A (priority given to) and Bank B (priority not given to) in 1994.

Targets	Bank A	Bank B
1. Total accumulated debit balance of fourth quarter of 1993	VND 54,000 bil	VND 270,000 bil
2. The average of real debit balance level of fourth quarter of 1993	VND 600 bil	VND 3000 bil
3. The calculated credit limitation for 1994 (the increased amount in comparison with 1993)	VND 120 bil	VND 300 bil
4. The apportioned credit limitation in 1994 (% in comparison with 1993)	120%	110%

This is the highest limitation in the year and at the end of the year.

That limitation is apportioned for each quarter of the year in growing direction. The calculation depends on concrete situation (see Table 5b).

Table 5b: Taking example above:

Quarter of plan	**Bank A**	**Bank B**
1. The beginning	100	100
2. At the end of first quarter	106	102
3. At the end of second quarter	110	105
4. At the end of third quarter	115	108
5. At the end fourth quarter	120	110

Each bank is informed about apportioned calculation of credit limitation in growing rate in comparison with average of the real debit balance level at the beginning of period as above. Its effect is leveling "the high time of credit" and avoiding the falsity that overstate the debit balance at the end of the year in order to receive high limitation or falsity which understates the debit balance in order to avoid cuts.

The credit limitation advance is calculated to be given to State budget by Finance Ministry, State Bank and approved by Government at the beginning of the plan year. This credit limitation advance is repaid during the plan year, and guaranteed with treasury bonds.

Realizing and regulating the credit limitation during implementation:

(i) Credit limitation is realized in each quarter of the plan year, and based on apportioned rate for each bank. It also plays a role of controlling ceiling to manage money supply, especially money issued to ensure that it is suitable to the paces of productivity and circulation.

(ii) During implementation action the credit limitation of previous quarter could be covered by this quarter, but total limitation is unchanged. Some banks do not completely use all their limitation while other banks need more than their portions. For objective reasons to meet their demand of productivity and goods demand, both should inform State Bank and in return State Bank should regulate and make some changes if necessary.

3.4.2. The interest rate of bank credit.

The credit interest rate of bank credit is the price of loan and the expense for money use. High or low interest rate directly affects input expense and income in credit business and it also affects the regulation of the market in relation to money supply and demand. Therefore it becomes a main tool by which State Bank regulates the money quantity.

The interest rate tools of State Bank include: Discount rate - the rate, State Bank uses when it lends commercial banks; the minimum deposit rate and the maximum lending rate as determined by State Bank to direct commercial banks when they borrow or lend.

(a) The discount rate is considered as whole sale price, that regulates the money amount to be put in circulation. In normal conditions, State Bank uses reasonable rate so money is monotonously high with inflation rate. Like our country this rate should be higher than normal and then input expense of commercial banks is higher when they borrow from State Bank. As a result their profit is decreased or output is equal to input given losses incurred. Finally money come to circulation is narrowed and slowed down. The discount rate also plays a role to lead and direct market rate. As the biggest lender and lender of last resort, the determination and announcement of rate by State Bank are always the signal that shows ups and downs of the economy as well as changes of policy on economic adjustment. So it is sensitive to the market as it manages the market.

(b) The deposit rate and the lending rate in the market determined by State Bank is a price frame of the managed market. They are determined in the financial market due to a brokers transaction to attract and bring savings in investment and to apportion reasonably the source to meet the demand of economic development paces. It also regulates money demand and supply relation, creates suitable direction of price, and keep price level stable. When the rate is high, money is deposited more, but with high rate, demand of fund borrowing from the bank decreases and vice-versa. In the first case money run to State Bank but in second case the money supply of State Bank needs to be higher. Therefore, the determination and use of the rate frame to narrow or widen credit amount means to limit or expand the money supply quantity.

In order to use effectively the interest rate tools, the following things need to be satisfied:

(a) To determine the rate. To become sensitive and to strive for the role of active management and put interest rate mechanism implementation in order.

(b) Calculation and determination of the rate are based on principles of positive real interest rate.

- Nominal lending rate is smaller than the average profit rate of economic industries.

- The average lending rate is bigger than average deposit rate.

- The average deposit rate is bigger or equal to inflation rate.

- The short-term lending rate is smaller than long term lending rate.

- The discount interest rate of State Bank is determined at three levels:

(i) The minimum of discount rate should be equal to the average deposit rate and the maximum of it is equal to 70 per cent of the short-term average lending rate.

(ii) The average discount rate should be higher than the average deposit rate and the maximum of it should be equal to 80 per cent of the short-term average lending rate.

(iii) The high discount rate (the rate of punishment is applied to tighten credit) should be higher than the highest deposit rate and ranging from 100 per cent to 120 per cent of short-term average lending rate.

3.4.3. The regulations on requirement reserve.

This tool directly affects money demand, money creation multiple and also increases the expense of credit in business running. It is used to combine with other tools to regulate and control the money supply in relation with each period.

The requirement reserve structure:

(i) The legal minimum reserve is put in a special account at the State Bank with determined percentage on balance of total mobilized deposit. This reserve percentage is stipulated in Article 45 of the decree of State Bank *"The maximum is at 35 per cent and the minimum is at 10 per cent"*.

(ii) Cash reserve at vault should be maintained at determined rate.

(iii) The balance on payment deposit account should be maintained at determined level.

The legal reserve level of cash and the minimum balance of payment account should be equal to the determined rate on special deposit account.

The real structure of legal requirement reserve is that the given amount of money is kept and not used to manage the solvency and to limit credit multiple. When the need to tighten credit, State Bank raises the reserve rate to be higher than the necessary level and when the need to expand credit, State Bank decreases it to be equal to the necessary level. In order to use this tool effectively, we need:

(i) To determine the reserve rate to be close to the aims of regulation. The regulation of legal reserve is only applied to credit institutions whose main functions are borrowing and lending of deposit.

(ii) The determination of reserve level is based on total deposit and each kind of currency according to the following principle: the high average balance is corresponding to high reserve, the reserve rate on demand deposit is higher than on time-deposit and the rate on short-term time deposit is higher than on long-term.

(iii) To redetermine the reserve level to be suitable to the reality and kind of commercial banks. For example commercial banks have the high ability to create money such as industrial banks and banks for foreign trade. This rate should be higher than the legal minimum level. Whereas bank of agriculture has low ability to create money because its loans are mainly in cash to farmers. Thus, it is necessary to determine a low rate in comparison with other commercial banks.

(iv) To calculate the average reserve level for each day in a month from the 16th of the month to the 15th of the month to come. For example, on the 16th day of the month credit institutions based on legal reserve rate and balance of all types of deposits over the past 30 days (starting point is 15th day of previous month) will calculate and manage the amount of legal reserve. That means that they will have to inform the State Bank of their amount of lack. If any does not comply with regulation it will have to pay an amount of punishment. The amount of punishment is calculated by the formula:

$$\begin{array}{c}\text{The amount}\\ \text{of punishment}\end{array} = \begin{array}{c}\text{Amount}\\ \text{of lack}\end{array} * \begin{array}{c}\text{The day with higest}\\ \text{rate of short term}\\ \text{lending rate level}\end{array} * \begin{array}{c}\text{Number of}\\ \text{late days}\end{array}$$

3.4.4. Open market operation.

We do not have enough conditions to establish and to operate in the open market. But in order to implement effectively the tasks of monetary policy, it is required to establish and to introduce it into operation. Over the past decades most of the countries in the world have used common monetary tools: open market activities, discount rate and legal reserve requirement. However, open market activities are given emphasis. Open market is a place where short-term bonds, especially treasury bonds are bought and sold. This market is organized and operated by State Bank to increase or decrease monetary base in circulation as required by the regulating tasks.

In comparison with other tools, open market operations have more advantages:

(i) It is active and sensitive in both money quantity and market interfering.

(ii) It creates conditions for State Bank to be active, to choose points in time, and chance to act and to help State Bank determine the implementing rate.

(iii) Selling and buying transactions are automatically carried out. As a result it affects directly the monetary base in circulation.

In order to establish and operate this tool in our country, it is necessary to create preconditions:

(i) It is necessary to implement immediately article 27 of State Bank decree : *"The State Bank and Finance Ministry would come to an agreement to act as an agent for State treasury on activities: (1) issuing Government bonds in short and long term, (2) paying principal and interest on bonds"*, and giving the commercial bill activities to State Bank to implement.

(ii) State Bank plays a role as creditor of State treasury to advance State budget in limitation with guaranteed treasury bonds.