# CHAPTER 4

# THE NECESSARY CONDITIONS AND THE PROBLEMS IN THE IMPLEMENTATION OF MONETARY POLICY

**4.1.** The most necessary condition to implement the monetary policy is to stabilize the social economics state, develop the market economy and good application of the open market economy mechanism.

The stages of implementation in Vietnam are not homogeneous between the country and the towns. In the country the merchandise rate is too low. The country market is undeveloped and do not relate with the town market and the international market. That is why the financial market is developing slowly and makes the monetary policy difficult to implement.

**4.2.** In applying the monetary policy effectively, we must organize the following:

(i) Develop the financial market in the towns and countries.

(ii) Develop a system of financial organization in all the territory.

(iii) The State Bank must be strong in order to play the role of policy control in the macroeconomy.

**4.2.1.** To organize and develop the financial market in all provinces. The market is regarded as the condition for regulating money in circulation in market economy. On the broader sense, the financial market is the system of markets which can attract all savings for investment in this market. People can sell or buy financial assets and to find a suitable and profitable way of investment. They can deposit money or borrow money from the bank, or sell or buy securities instead of keeping much cash in a safe-box.

Financial market includes money market and stock market. These markets transfer funds and regulate capital supply and demand through technical measures. Price is the common language-for example: The lower interest rate the lower the risk and the higher interest it means higher risk. Borrower and lender must think in order to get the best alternative. Taking part in the financial market means that the lenders will receive dividend on their money and the borrowers can carry out their investment plan, which can yield high profit in excess of interest from borrowing money. Market always reminds the participants to consider between profit and loss, and to know clearly that money can create profit, and money must be paid on time (including interest and principal).

Financial market is very sensitive to mobilizing funds to meet the demand of production and business, to accelerate money in circulation, and to balance the supply and demand of money. When the economic growth rate needs higher money volume, this market will transfer this volume to circulation. Through this market, central bank can implement its role, to control money supply in the market and to decide the monetary policy. It is necessary to diversify financial instruments in the developed financial market. Beside money as the main means, there must be many negotiable payment of instruments (commercial bills, treasury bills, bonds, etc). Each of them needs to be based on economic and legal conditions in order to ensure their effectiveness and security in circulation. In Vietnam today, the commercial bills have not been issued. However only treasury bills, certificates of deposit and banking vouchers are commonly used.

On the way to set up a financial market in Vietnam, the interbank money market is the first step. This market has been set up and is in operation. However it needs to be noted that:

(a) The interbank money market is the short term capital market, in which the credit organization can regulate the surplus and deficit of funds arising from day to day business and from the obligation to ensure the required reserve of State Bank of Vietnam. It means that the need for credit institutions needs funds for two reasons: when the credit expansion exceeds their own resource and to carry out the required reserve in order to avoid borrowing. The credit institutions have to mobilize funds or to reduce the lending credit size.

(b) In the interbank money market, the money market instruments consist of not only deposits, but also the negotiable documents which can be transferred or discounted. These documents ensure credit payment, in order meet the demand of the economy.

(c) With these reasons, the Central Bank controls (i) horizontal credit relations - the credit institutions make loans to one another at an agreed interest rate (subject to the interest margin of central bank) and (ii) vertical credit relations - when the credit institution cannot satisfy their needs, the Central Bank is considered as the final lending resort.

Therefore, the interbank rate is an important instrument that the State Bank uses to regulate money in circulation. The State Bank uses the credit line, the discount rate and the required reserve to affect the credit volume. In order to tighten credit, the discount rate has to dominate (or overwhelms) the market interest. The required reserve must be stipulated logically and for those who do not follow this stipulation will be penalized.

However, the interbank market can only be developed when the money market throughout the country is active. Money market is known as a market where the credit institutions and their customers meet. Their customers include the people who need funds and people who have a lot of money and are able to lend their money out. In this market, a credit institution is a centre for regulating money demand according to the areas and the scope in which they want to attract capital in order to expand credit and to develop production and business. At the same time, the intermediary service is developed as well. As a result, the flexible and effective activities of money market will bring about the following results:

(i) The transfer of savings into investment in the relation between supply and demand available in the market.

(ii) The creation of money and the increase of money supply volume which can cause inflation.

(iii) For profit, it can stimulate production, and develop money circulation. But it also can cause market instability.

The most important condition for stablishing effectively the developed money market is to credit a multi-form system of credit organization in all the countries with modern operations in order to satisfy the credit demand of the banking system in money market. In the developing of a money market, we must also organize the stock exchange. Stock exchange is the place where you can buy and sell securities which funds are regulated in the stock exchange market. The stock exchange market is a financial institution which attracts funds for the economy. In the developed countries, stock market is being developed because this market is a place where long term funds can be transferred effectively.

Thus the financial market will not fully develop its activities if it has not got an active stock market.

In Vietnam, the setting up of a stock exchange market is necessary but the problem is that how to have economic base and legal base to bring this market into the most effective result.

**4.2.2.** Setting up a financial intermediary system which ensures financial strength and legal ability.

(a) To encourage and give favourable conditions for setting up commercial joint-stock banks, financial joint-stock companies belonging to private economic sectors, the incombanks (industrial bank and commercial bank) in the cities, the rural stock bank for rural provinces, and some specialized financial corporation in the big economic central which can compete with state-owned banks to produce various services and products of high quality.

(b) It is necessary to organize and strengthen the state-banks:

(i) Banks for agriculture should be changed into specialized banks - Rural Development Bank.

(ii) To separate saving banks from state-owned banks and to set up one credit institutions.

(iii) To end the existence of provincial banks.

(iv) To delegate the whole right for those banks, who can run their business well in the market.

(c) Strengthen the state commercial banks, and ending the intermediary bank in provinces. Give them the necessary and favourable conditions to operate in the market mechanism.

**4.2.3.** The State Bank must always manage and control the monetary policy for realizing the forecast objectives by using efficaciously the instruments of the monetary policy.

(a) The discount rate: This is a very important instrument but it is not used in conformity with its role. This rate has been used as a mean to divide profit but has not been used as the role of a regulator. For instance at present, the lending rate of the State Bank to the agricultural bank is 0.9 per cent per month, to the commercial bank is 1.2 per cent per month and the borrow rate of the commercial bank to borrower is 1.6 per cent per month and the saving rate is 1.2 per cent per month.

That is why we must change the role of discount rate:

(i) Proclaim only one rate weekly in the money market.

(ii) The rate level depends absolutely to the regulated money circulation.

(iii) The discount rate must oblige the credit institution to borrow from people and restrict borrowing of the State Bank (unless the State Bank decreases the rate for increasing the money in circulation).

(b) Implementing the mechanism of real positive interest rate is the decisive factor to change banking business into self-supporting one. It hopes to eliminate the subsidized credit. It also requires that the operating mechanism of the State Bank should be sensitive to the relationship between money demand and supply in the market. In order to ensure the synchronism and relative stability of banking interest rate, the mechanism of interest rate should posses the following factors:

(i) Has a sensitive system of interest rate that interacts with one another, for example, discount rate - the rate determined by State Bank is applied when State Bank lends commercial banks and credit institution.

(ii) Establish a reasonable frame of interest rate and create conditions for credit institutions that is active and sensitive to their business. This interest rate frame also controls and manages credit quantity actively.

(iii) Regularly inspect and control the interest rate policy.

(c) Credit limitation: At present in Vietnam the credit limitation is a really effective tool because State Bank uses to apportion and regulate credit quantity to be suitable to the requirement of economic growth. This is not the amount planned by credit institutions to be submitted to State Bank but is planned by State Bank to apportion the credit. Therefore, this tool should be regularly and strictly used. During the implementation process, the increase or decrease of credit limitation depends on changes of economic targets.

(d) Legal reserve requirement: This tool is being used to ensure the ability to pay. The 10 per cent legal reserve policy of State Bank applied to all credit institutions and thus has been maintained for a long time since 1991. In order to use this tool effectively in monetary policy implementation, there are requirements to be satisfied:

(i) To establish the structure of legal reserve as required, including required collateral money at State Bank, the cash reserve at vault of credit institutions and reserve on accounts of credit institutions opened at State Bank. The required collateral money level has to be maintained at State Bank and stipulated by State Bank decree, article 45 "*The minimum of the required reserve rate is 10 per cent and the maximum of it is 35 per cent of total deposited at credit institutions*", and is being realized according to decision No 22 NH/QD enacted on March 2, 1991 by Vietnam State Bank governor.

In order to carry out the above requirements, it is necessary to enact more regulations on cash reserve level and reserve level on deposit account. The total percentage of both should be equal to or more than legal reserve rate level.

(ii) To control the ability to create money, and to regulate money supply that is suitable to the demand of monetary policy and to ensure the ability of credit institutions to pay. Therefore, the legal reserve rate should be regularly regulated in each month.

(iii) The legal reserve is only applied to credit institution who mobilizes funds to lend as stipulated by regulations of State Bank. The calculation depends on deposit balance of each kind of money. Therefore, it is needed to separate credit institutions and their mobilized money into kinds on which the legal reserve rate of each kind is determined.

As experienced by some countries in the world, the percentage of demand deposit is highest and ranging from 15 per cent to 20 per cent, the percentage of time deposit in short-term (3 months to 9 months) is 8 per cent to 12 per cent, and long-term deposit covers about 3 per cent to 8 per cent. These rates are based from the calculations of two kinds of reserve which are based on the required collateral rate. So a credit institution only mobilizes money in the form of time-deposit. In this case the applied collateral rate would be lower than the rate stipulated in the decree.

(iv) To inspect and conciliate each month in order to regulate and discipline any institution who does not comply with the stipulation.

### 4.3. The issues relating to monetary policy implementation need to be soon settled.

**4.3.1.** Giving a lending task with funds source from "**NATIONAL FUNDS FOR JOB CREATION**" to State treasury is not suitable to

State Bank decree. As a result, a part of credit activities is out of State control, and it also does harm on monetary policy management. Therefore, this task should again be given to the bank (by the Government), especially people´s savings institutions.

**4.3.2.** The open market needs to be organized and put in operation. In order to create material conditions for this market to operate, firstly it needs the following:

(i) (As stipulation of the decree) to implement soon the mechanism in which State Bank acts as an agent for State treasury to issue treasury bonds as well as national bonds.

(ii) To carry out the mechanism in which the State Bank and the commercial banks lend to State budget. Those activities are guaranteed by short-term treasury bonds.

(iii) State Bank lends credit institution in the way that State Bank discount debt papers or credit institutions pledge with the debt papers (treasury bonds, certificate of deposit, enterprise bond, borrowing papers, etc.) in the short-term.

(iv) State Bank should consider to issue State Bank bonds, the name of the word be "**MONEY-STABILIZING BOND**" or "**CENTRAL MONEY BOND**". These bonds are tools of open market to mop-up money from or into circulation. The legal and structural conditions should be prepared for forming and operating this market.

**4.3.3.** It is necessary to have the law on deposit insurance, and to establish a organization whose functions are to insure deposit. During this period, the Government should issue a legal document on deposit insurance and establish an organization whose functions are to insure deposit.

The organization whose functions relating to deposit insurance is an organ of the State and is organized by co-operation between Finance Ministry and State Bank. The State Bank is the managing office and responsible for managing and directing the activities of this organization who mobilizes money for lending including: time-deposit, demand-deposit in both foreign and domestic currency.

The deposit insurance institution has functions to repay customers when a member bank become bankrupt. However, the main function is the role to support and insure the member bank to be stable and secured. Should a member bank of the system who is likely to lose its solvency, the deposit insurance institution will apply some measures to help overcome insolvency.

The capital of the deposit insurance institution includes:

(i) The non-interest bearing equity at the beginning is financed by State Bank or finance ministry.

(ii) The capital contributed by member credit institutions in the form of insurance fee. This fee, according to some countries in the world, is equal to 1/15 per cent to 1/10 per cent of total mobilized funds.

(iii) Accumulated funds from operation-when the capital from insurance fee collection is equal to borrowing fund, in this case the insurance institution should repay the borrowed funds to Sate Bank and Finance Ministry.

When the amount of insurance funds reaches the highest figure that means it has enough capital to operate. In that case insurance fee is contributed by member institutions, and could be lowered as proposal of deposit insurance institution.

**4.3.4.** The Government or Prime Minister should enact a decision that forms the content of monetary policy, and gives the concrete duties to State Bank in making and realizing the monetary policy under the principles and orientation of the Government.

**4.3.5.** It is necessary to enact synchronous system of law and regulation to ensure the financial system can operate in a secured way. The most important of these laws are the banking law (at present, there is the banking decree), trade law, credit law, deposit insurance law, law on ownership and inheritance and law on liquidation. While waiting to have an official law now the Government should enact these sublaws immediately.