HOW TO DEAL WITH THE SHORTAGE OF DOMESTIC CURRENCY

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In the years 1985-88, the shortage of cash under the centrally planned mechanism made the banking system paralyzed, and now the shortage of domestic bank bills becomes a worry to commercial banks. This situation is unacceptable in the market economy. This problem, if not solved in time, will lead to disastrous consequences.

1. Causes of the shortage

- In the first half of 2001, the total negotiable instrument rose more slowly than it did in the corresponding period last year while the economic situation was improved: the GDP growth rate was estimated at 7.1% (higher than the same period last year); the industrial output rose by 14.1%; the agricultural output by 3%, export 14.8% and import 9.6%. The smaller increase in the total negotiable instrument as compared with the economic growth rate should be re-examined. When the central bank refuses to increase the money supply, the shortage of bank bills faced by commercial banks seems inevitable.

- Total bank deposit mobilized by banks in the first half of 2001 was low as compared with the corresponding period last year. This means that the volume of cash held by the public is on the increase. This tendency was affected by the exchange rate, interest rate and changes in markets for real estate and securities. The exchange rate has been stable for a long time. There is no difference between interest on bank deposit in domestic and foreign currencies. And the real estate market is brisk. These facts encourage the public to hold domestic currency as an instrument for storing wealth and engaging in money trade.

- Companies are badly in need of foreign exchange and they are ready to borrow in the domestic currency to buy foreign exchange and thus causing greater shortage of cash to commercial banks.

2. Solutions adopted by the SBV

- The required reserve ratio has been reduced from 5% to 3%, and even to 2% for the Bank for Agriculture and Rural Development.

- The base rate was kept at 0.65% a month and commercial banks are allowed to add from 0.3% to 0.5% to this rate. The interest rate on short-term loans in foreign exchange is based on the 3-month SIBOR rate plus 1% a year, and the 6-month SIBOR plus 2.5% a year for long-term ones.

- The refunding rate was reduced from 0.5% to 0.4% a month and the discount rate from 0.45% to 0.35% a month.

- Open market operations were used for increasing or reducing the money supply.

These solutions were adopted by the SBV in an effort to stabilize the money supply and to a certain extent, encourage commercial banks to increase their supply of credit. Having predicted the shortage of domestic capital in banks, the SBV made Decisions 893 and 894 on July 17,2001 on exchange of domestic currency for foreign exchange between the central bank and commercial banks. However, the shortage of domestic currency hasn't been solved and gone from bad to worse because of the following facts:

+ Cuts in reserve requirement could make the interest rate lower and supply of credit by banks increase, but this didn't happen when the source of domestic capital in banks was limited. Cuts in the base rate will produce the same result.

+ Refunding and discount rates offered by the central bank are attractive to commercial banks. If this is an effort by the central bank to affect the lending rate, and not an encouragement to get more loans from the central bank (that is, the central won't supply more capital to state-owned commercial banks), these cuts in refunding and discount rates will fail to solve the shortage of domestic currency.

+ Open market operations are considered as a good instrument for regulating the money supply, but these operations attract only state-owned commercial banks while others didn't take part in this market. This means that these operations didn't produce intended results and they are still useful theoretically.

+ The exchange of foreign exchange for domestic currency can't solve the shortage of domestic currency because a 1.5% fee per quarter (as stipulated by Decision 1033) is too high for commercial banks when they have to pay both interest on foreign currency they deposit with the central bank and this exchange fee (those two payments amount to 1% a month).

The following are our calculations about the exchange of foreign currency for domestic currency by the central bank:

- Suppose that the deposit rate is 0.35% a month for deposits in foreign currency and the bank can deposit the sum of foreign currency with a foreign bank for the same interest.

- It's also supposed that the exchange fee is 1.5% per quarter or 0.5% per month; the interest rate on loan in domestic currency is 0.65% a month.

When the bank exchanges one million dollar at the rate of VND15,000 to the dollar, what it can gain are:

- Interest on lending the sum of domestic currency: 0.65% * 3 months * 15,000 = VND292,500,000.

- Better supply of credit and customer loyalty.

- Some profits when the exchange rate falls.

And what it can lose are:

- Interest payment to customers or loss of some profits when the sum of domestic currency laying uninvested: 0.35% * 3 months * 1,000,000 * 15,000 = VND157,500,000

- Exchange fee for the central bank: 1.5% * 1,000,000 * 15,000 = VND225,000,000

Thus the bank has to spend VND382,500,000 or VND190,000,000 higher than the sum it could gain from lending the sum of domestic currency. It could suffer a total loss or bad debts or a smaller loss when the exchange rate rises.

These analyses explain why commercial banks aren't interested in the exchange of foreign currency for domestic one.

3. Suggested solutions

a. Adjusting the exchange rate:

We should admit that the central bank has succeeded to a certain extent in controlling the exchange rate. On Feb. 25, 1999, the SBV issued two Decisions on the exchange rate: Decision 64/1999/QĐ-NHNN7 on the exchange rate of the VND to the dollar, and Decision 65/1999/QĐ-NHNN7 providing methods of determining the exchange rate used for banking institutions allowed to trade in foreign exchange. These decisions started a new mechanism for controlling the exchange rate in Vietnam: instead of publicizing the official rate, the SBV publicizes the average rate offered by the inter-bank foreign exchange market on a daily basis. Commercial banks can decide their exchange rate to the dollar based on this average rate provided that the difference between their exchange rate and the average rate publicized in the previous trading session doesn't exceed 0.1%. As for other foreign currencies, commercial banks are free to adopt any exchange rates.

A two- year period after these decisions is long enough for us to review them and decide whether they are still appropriate to the economic development or not. At present, these decisions seem to be an obstacle to the banking business. The 0.1% limit has become a narrow frame that worsened the shortage of domestic currency. When the exchange rate on the free market changes rapidly, commercial banks find it difficult to cope with these changes because the exchange rate they adopted is controlled strictly and many business opportunities are missed. In addition, the central bank didn't control the exchange rate between the domestic currency to other foreign currencies, thus commercial banks can use other currencies to change the dollar to the domestic currency and vice versa without limit. So the central bank had better remove the 0.1% limit on the exchange rate to the dollar and consider it as a new development in the mechanism for controlling the exchange rate.

b. Reviewing the exchange fee:

With the interest rate of 4.5% a year on loans in the dollar and the interest rate of 7.8% a year on loans in the domestic currency, the reasonable difference for a 3-month exchange is 0.9% because (0.78% - 0.45%) * 3 months: 12 = 0.825%. So the central bank had better reduce the exchange fee to encourage commercial banks to change their dollar reserves to the domestic currency.

c. Increasing the money supply:

Lowering the interest rate without increasing the money supply will produce no effect. The open market operations will have little meaning when the money supply doesn't change. The best way to solve the shortage of domestic currency is to increase the money supply. And we still wonder why the central bank refused to issue more money when falls in market prices had become a worrying situation■