

ON RESERVE REQUIREMENTS RULED BY THE BANKING BILL

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peasant banks at branch office, in the city of Hanoi and in
Hai Phong, and savings associations in rural areas
and towns will join together to form a national
commercial bank. This will be a great step forward
in the development of the country's economy.



Article 27, Point 2, of the Banking Bill reads "The State Bank sets reserve requirements for each kind of bank deposit". In this spirit, the Banking Bill removed required reserve ratio set by the Ordinance on the State Bank issued in 1990. The problem seems simple but causes a lot of controversy.

Every regulation set by law must be carefully considered because a small mistake can lead to disastrous consequences. Required reserve ratio a very complicated problem which is difficult to agree about. We had better study regulations set by the Ordinance on the State Bank in order to find out correct appraisals.

Article 15 of the Ordinance on the State Bank reads: "The State Bank rules that all member banks must keep reserve from 10% (minimum) to 35% (maximum) of their bank deposits. The board of directors of the State Bank can raise the reserve requirement to a level higher than 35% if need be, and is under obligation to pay interest for the difference".

Why is there the 10-35% reserve bracket for bank deposits? This bracket originated from an estimate of the future development of the two-level banking system in the market economy. However, it comes from foreign experience which we had to absorb without making analysis and comparison because at that time there was no commercial bank, and we had no chance to study the banking systems of countries having the same socio-economic conditions as Vietnam. Makers of two Ordinances on Banking have applied foreign experience to Vietnam banking system when this system started to adapt itself to the market economy and many problems haven't been studied minutely.

Reserve requirements are considered as a tool in realizing the monetary policy and regulating the money supply. In Vietnam, the better part of the money supply is cash issued by the State Bank, whereas in developed countries, money in the form of banknotes and coin represents only a small part of the money supply, the best part includes private-sector current and deposit accounts. As for call deposits, in most countries, the law forbids paying interest to these accounts, therefore commercial banks in foreign countries are very glad to receive call deposits. These accounts usually represent from 10 to 35 percent of the total bank deposits, that is why banks are ready to keep from 10 to 35 percent of their total

deposits in legal reserves. In Vietnam, with one-level banking system, customers at that time were not allowed to open current accounts or call-deposit accounts, so these accounts weren't as popular as savings accounts or fixed deposit accounts. In other words, banks have to pay interest to most accounts.

When commercial banks are allowed to be formed according to the two Ordinances on Banking, the old way of attracting dead money wasn't changed, that is, banks have to pay interest to all kinds of account, therefore all commercial banks suffered losses because they were forced to keep at least 10% of bank deposits in reserve, and pay interest for that 10%, not to mention some other liquid assets which were kept in their vaults and produced no profit.

In such a condition, the State Bank could choose between supplying subsidies to commercial banks to cover interest paid to customers and allowing all customers to open current accounts, and the latter was approved.

Another problem needed to be taken into consideration is the multiplier effect of increased (or decreased) bank deposit on the money supply, that is, theoretically, the original deposit of one dollar in a commercial bank could expand into many dollars in deposits in the banking system and many dollars in credit. The multiplier effect is affected by reserve requirements. By issuing banknotes and using reserve requirements, the central bank can control the growth of the money supply and of the economy as well. In principle, the higher the reserve requirement, the tighter the money, and vice versa. In other words, when the reserve requirement is low, member banks are encouraged to supply more loans, that is, to increase the money supply; and when the reserve requirement is high, the supply of loans is discouraged and the money supply is reduced. Moreover, forcing commercial banks to deposit legal reserves with the central bank is a tool for the central bank to control the banking system and put commercial bank under control.

The money multiplier coefficient reflects the interaction between the

amount of money supplied and the interest rate controlled by the central bank. This coefficient defines the money multiplying capacity of commercial banks. That is the capacity by which banks change deposits into loans. In certain periods with specific requirements, the central bank carries out the cheap money or the tight money policy, that is, increase or decrease the required reserve ratio in order to increase or decrease the money multiplier capacity of banks.

Like other monetary instruments, reserve requirement has two-sided effect, so in specific conditions many studies must be carried out with a view to making the best use of this instrument. Moreover, the economy always keeps on changing and any instrument will come to a point where it produces no desirable effect. It's the

to become deposits in banks and thus, the money multiplier coefficient will be small. The money multiplier theory implies that any change in the monetary base will lead to changes in the money supply according to a stable coefficient. However, in fact, there are not always ideal conditions for this theory. These conditions will more likely come into existence in the US or Germany than in France or Vietnam where the money multiplier effect seldom comes into operation or operates irregularly and unsteadily.

The above-mentioned analyses help us see functions of reserve requirement instrument, with its form of the required reserve ratio as a basic model of the monetary policy, while its variables as specific models which are affected by socio-economic conditions, national tradition, organization and capacity of the central bank of a specific nation; and at the same time, it reflects social conflicts and prominent problems in a specific period that needed to be solved. The central bank of each nation will work out the required reserve ratio of its own which is considered as appropriate to the current conditions of the country.

Although the central bank can choose the required reserve ratio of its own but it must respect the general principle, that is, the ratio can vary from the highest to the lowest levels. These analyses show that it's not easy for the central bank to set the highest and the lowest ratios. Up to now, the 10-35% bracket set by the Ordinance on the State Bank is still the basic legal conditions for the innovation of our banking system. We need more conditions and operations to help the banking system work effectively and help the central bank carry out the monetary policy successfully. To create these conditions is a matter of great urgency now.

To remove the required reserve ratios is not the best solution. The problem is to find out required reserve ratios appropriate to our current conditions in order to develop the economy and integrate into the regional and the world economies.



time for us to replace it with a new one.

There is an interaction between reserve requirement and interest rate. This is the relation between the amount of money supplied and its value. The more important the interest rate, the less important the reserve requirement. On the other hand, in an economy where there is no stock market and other operations which can deal successfully with changes in the interest rate, the reserve requirement becomes the most important instrument to the central bank.

It's worth noting that the money multiplier coefficient is appropriate to an economy with a stable amount of money supplied, not to a developing country. As long as the domestic currency is weak in its function as a store of value, then the amount of cash money supplied is still big. Banknotes issued by the central bank are slow