UNUSUAL FLUCTUATIONS OF BANK DEPOSITS AND DANGERS TO THE BANKING SYSTEM

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In 1996, bank deposits witnessed unusual fluctuations, from a surplus to a shortage, deposit rate fell sharply and then rose sudddenly. In 1997, many banks faced a danger of a bank run. Recently, there has been a financial crisis in Thailand and 2 Korean banks have faced financial difficulties. All these facts need to be studied carefully in order to find out instruments for protecting the banking system.

In 1996, bank deposit increased strongly in the first nine months, therefore all banks had to lower the deposit rate, some banks even refused fixed deposits made by customers because they were afraid that they couldn't find new borrowers. The ratio of loans to deposits was very low, some banks could only loan 50% of their deposits. In December, joint stock banks in HCMC stopped lend-

ing when customers took deposits out of them and put in the Bank for Agriculture because this bank issued new certificates of deposit promising to pay an interest rate of 14.2% a year, higher than the lending rate-ceiling of 1.25% a month.

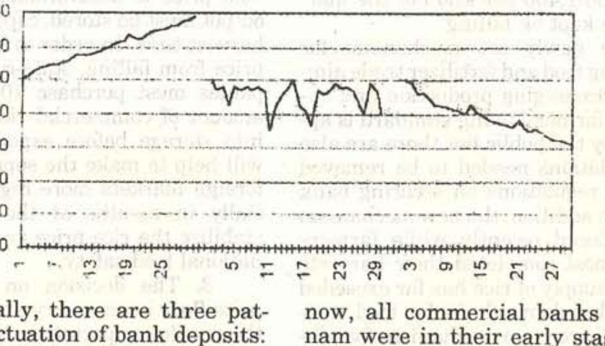
At the begining of 1997, some banks lived in daily fear of a bank run when the press reported on bankruptcies of Epco and Minh Phụng. The danger to them is that they are allowed to draw only a small amount from their required reserves held by the State Bank when there is a danger of a bank run. They also meet with difficulties in borrowing from the interbank market, they can only mortgage T-bills to other banks but the amount of T-bills is limited because the Treasury issued only VNĐ50 billion worth of T-bills to nearly 50 banks in 1996.

Required reserves weren't used as provision against a bank run but they were frozen regardless of protest from commercial banks. In order to solve this difficulty, it's necessary to study patterns of fluctuation of deposits in commercial banks.

1. Three patterns of fluctuation of deposits

Since 1987 when the two-level banking system was adopted, bank managers still relied on the State Bank to deal with falls in deposits because at that time, commercial banks have just come into being and the best part of their working capital was supplied by the State Bank, deposits in banks represented only a small percentage. Up to the 1990s, many private commercial banks were established and developed, banks deposits started to increase. Fluctuations of deposits didn't become a danger.

Fluctuations of bank deposits



Generally, there are three patterns of fluctuation of bank deposits:

(1) Acceleration: as shown in the first part of the graph, the bank deposits increase steadily. This acceleration is to be expected of newly formed banks that meet with no difficulty in doing their business. This acceleration enables banks to supply more and more loans and causes no worry to bank managers.

(2) Irregular fluctuations: as shown in the second part of the graph, these fluctuations limit banks' ability to supply loans and reduce bank profits. In this situation, the bank can only lend or invest 70% at most of its deposits.

(3) Deceleration: as shown in the last part of the graph, this deceleration reflects a decline. In this case, the bank has no alternative but to try to collect debts with a view to dealing with withdrawals of funds. If the bank fails to improve its situation, it will have to file a petition in bankruptcy.

2. Present potential dangers to the banking system

After the promulgation of the Ordinance on Banking (1990) up to now, all commercial banks in Vietnam were in their early stage of development and bank deposits increased steadily because of a high deposit rate. Only a few commercial banks faced massive withdrawals. But at this point, certain potential dangers started to take shape:

a. Deposits from abroad: when the deposit rate in Vietnam is much higher than those in neighboring countries, it attracts a lot of deposits from abroad and leads to a credit surplus in the banking system. At that time there was a danger of massive withdrawals. Eventually, in 1996 when the interest rate was lowered four times, massive withdrawals took place and all banks ran short of capital. Have deposits from abroad returned to their home? There is no exact information about this but this is certainly one of the causes of the sudden fall in bank deposits last year.

In the first half of 1997, many banks were dealing with decreases in bank deposits, but bank managers had to find solutions to this problem by themselves and closed their mind to the idea of getting help from the State Bank because they could borrow nothing from the interbank market.

b. Does a steep fall in interest rate-ceiling lead to a fall in bank deposits? On July 1,1997, the interest rate-ceiling reduced from 1.25% to 1.0%. This reduction was made because the price index fell, paying no attention to financial difficulties facing commercial banks, therefore this reduction was not welcomed. In other words, this reduction made danger of a fall in bank deposits more serious and made no improvement to commercial banks' performance.

Even banks with great difficulties found it impossible for them to borrow something from the interbank market. Thus, required reserves held by the central bank haven't been used as emergency funds for the banking system. This problem must be studied and discussed carefully.

3. How to use require reserves for preventing such dangers?

Reserve requirement came into being after a bank run that took place in the Great Depression of the 1930s and caused a lot of banks to fail. Thus, the first purpose of required reserves is to provide commercial banks with access to emergency funds.

After that, there were many other instruments for protecting the interest of depositors, such as deposit insurance funds and depositors had more confidence in the banking system. A run on a sickly bank produced almost no effect on healthy banks. Since then, the banking authorities started to pay more attention to the regulatory effects caused by the reserve requirement on banks' demand deposit creation.

Some banking officials in Vietnam have been a bit much when they stopped considering required reserves as emergency funds for the banking system, and they worshipped the idea of freezing required reserves. That is why they protested against the act of using required reserves to loan to commercial banks that were short of reserves.

After a workshop on required reserves and exchange rates held in June 1995, the State Bank allowed commercial banks to withdraw funds from the required reserves in times of difficulties but these borrowings would be returned within a fortnight. More exactly, commercial banks were allowed to withdraw only one tenth of the amount they had deposited with the central bank in order to repay depositors.

Let's study an example in order to grasp the situation.

A bank has a total deposit of 1,000 billion, it sets aside 100 billion to meet the reserve requirement and lends or invests 800 billion, it also keeps 100 billion as a provision (this percentage is rarely seen in reality). If the total deposit reduces by 100 billion, the bank will be in a state of temporary insolvency. It can withdraw 50 billion from the required reserve in order to repay depositors or allocate to its branches. But a fortnight after, it has to deposit 40 billion with the central bank as required. Thus, it is allowed to withdraw only 10 billion (or one tenth of the decrease in its deposit). Can it has confidence in a provision equalling only 1.1% of its deposit?

If the central bank can supply overnight loans to banks in a state of temporary insolvency provided that these banks stop loaning, commercial banks will feel certain about their business and the central bank will be able to keep a close eye on the operation of those banks. When a bank needs funds to make payments through interbank payment system, it can get short-term loans from the central bank, that is, a bank that runs short of funds because it has to make payments through the interbank market, it can get loans from the central bank, then why doesn't a bank that runs short of fund because of other causes do the same? ■