

# CONTROL OVER INTEREST RATE AND DIFFERENCE BETWEEN LENDING AND BORROWING RATES

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In 1996, there were many changes in the interest rates and the most remarkable fact was that all four changes taking place in 1996 had a common aim: to lower interest rates. Up to October 1996, the interest rate-ceiling reduced to 15% a year, decreasing by 40% in comparison with a ceiling of 25% in 1995. This reflects a strict regulation on interest rates that explained achievements in 1996: a lower inflation rate and the stability of the domestic currency and economic growth. Lower interest rates have encouraged businesses and customers to look for bank loans and have helped to reduce the difference between bank rates charged on loans in foreign and domestic currencies, thereby reducing dishonest speculation in this difference between rates.

Another fact is that a change in the difference between rates charged on short- and long-term loans: interest paid for long-term loans became larger than what paid for short-term ones. This change has encouraged banks to attract more deposits and supply more medium- and long-term loans.

Banking regulators, by removing restrictions on interest rate scale and fixing only a ceiling on lending rate, have liberated the system of commercial banks and have allowed them to adjust lending and borrowing rates to market demand and supply forces.

However, besides these achievements, the interest rate regulation has revealed several shortcomings:

## 1. Abnormal changes in borrowing rates offered by commercial banks

In mid-1996, borrowing rates offered by commercial banks decreased simultaneously and then,

crept up again by the year's end. Fluctuations of interest rates are common in the market economy provided that they don't break banking regulations, but simultaneous rises and falls in interest rates last year were unusual in an economy with a low inflation rate and a high growth rate.

In mid-1996, the ceiling on interest rate was reduced and banks held too many large deposits with the result that all banks were forced to lower interest rates. Their decision was reasonable, but they were unreasonable in refusing fixed deposits made by customers. All fixed deposits of short terms, from three to nine months, were rejected by most banks. Small savers were put at a disadvantage and didn't know where to invest their money in: the property market was in the doldrums and too risky, there was no stock market and informal credit clubs were fragile. To the end of 1996, the demand for capital became greater and even ordinary people could learn about this because the borrowing rate rose again, from 0.6% to 1% a month for 3-month deposits, banks welcomed all kinds of fixed deposits again, they even agreed to 13-month deposits which have never been accepted before. To savers, high borrowing rates are always all right, but such changes in interest rates could easily make us worry: it seems that the banking system has no strategy for their development.

## 2. Rises in interest on current accounts: an unwise move

Of rises in interest rates, the rise in interest on current accounts has stimulated a lot of interest. In principle, customers open current accounts so as to cash and draw cheques. In many countries, the cus-

tomers receive no interest and may pay bank charges. In Vietnam, in order to lure customers and their deposits to banking services and because of high interest rates paid to other bank deposits, Vietnamese commercial banks have paid some interest on current accounts, but in the long run banks had better stop paying interest on them.

Looking back, we can easily see that changes in interest on current accounts are unruly, complicated and aimless: from 0.1% a month, it increased to 0.5%, and then 0.7%; it decreased to 0.1% for a while; and at the end of 1996, along with other rates, it was raised to 0.4% and even to 0.7% at some banks. The public have become accustomed to changes in interest rates when banks competed with one another for this source of cheap capital. This competition produced a bad consequence: the habit of expecting no interest on current account was broken.

## 3. A difference of 0.35% between interest rates on bank loans and deposits

This regulation has aroused a lot of controversy both inside and outside the banking system.

Supporters of this regulation argued that this difference (or margin) could help to protect depositor and encourage banks to pay more attention to management and supervision of their business, because well-managed banks can make handsome profits by reducing cost.

However, in our opinion, it's unreasonable to force all banks to observe this difference and the above-mentioned argument is not strong enough.

Firstly, you can't order the same shoes for everybody.

Banks operating in different areas pay different costs and reducing



cost requires a lot of time and energy: for example, banks in rural areas have to cover higher costs as compared with other banks and they find it very difficult to reduce them because most of their potential customers live in scattered villages and have low income. It's hard for these rural banks to attract large deposits and make enough profits to cover funding costs. These costs are high against their will regardless of how well these bank are managed. If they are forced to observe the difference of 0.35%, their profit will certainly become smaller. On the contrary, other banks that are more conveniently situated can attract much bigger deposits and make handsome profits while their funding costs are lower. Therefore, it's unacceptable to allow unequal opportunities for banks of the same managerial skills.

Secondly, this difference is harmful to fair competition.

As we know, in the market economy, all companies must to expose themselves to the competition, but there will be no fair competition between banks under the regulation on the difference of 0.35% between deposit and lending rates. Banks with favorable conditions and low running costs can easily accept as low income as other banks do in order to raise the deposit rate and reduce the lending rate.

This situation, accidentally, will allow certain banks to gain an advantage over others.

Thirdly, this difference of 0.35% is unrealistic.

In fact, we can't work out the real difference between lending and borrowing rates because term of loan and term of deposit aren't always the same.

We can only work out an exact difference when the bank can get deposits and supply loans of the same amount and the same length of time, but in fact, such a thing never takes place. In certain banks, the better part (from 60% to 70%) of their working capital comes from call deposits, but all customers always demand a fixed term for loans from banks. To strike the right balance between call deposits and term loans is very risky and the bank deserves some profits for this.

So how can we work out the exact difference between rates when these rates always have different terms?

Fourthly, this difference, if it can be worked out, doesn't reflect banks' loan quality.

The Circular 05/TT-NH1 issued on Aug.17,1996 by the State Bank, besides other guidelines, also presented the method of working out average lending and deposit rates within an accounting period used for inspecting the task of ensuring the difference between rates. This method assumes that the monthly average lending rate depends on the total interest on loans received in a month, and the average deposit rate depends on the total interest paid to bank deposits in a month. But in fact bank interest received or paid in a month depend on many other factors:

- Certain loans yield interest on a monthly basis, but some others on a quarterly basis.

- Some banks receive all payable interest when due but some others receive only 60% or 70% of it.

- In order to encourage customers to make deposits, some banks can pay interest right away when the deposit is made instead of waiting until the end of the term.

- The ways used by banks to collect interest on loans or pay interest to bank deposits are different and this will certainly affect the real average lending rate and real average deposit rate, that is, affect the difference between them. The following example can make this argument clearer:

The cash budget of the bank A for January 1997 is as follows:

- Total interest received: 1,200 million

- Total outstanding loans: 100,000 million

- Real average deposit rate: 0.8%

- a. If the Bank A receives all interest of 1,200 million, the real average lending rate will be:

$$1,200/100,000 \text{ million} \times 100 = 1.2\%$$

In this case, the difference between rates in the Bank A is:  $1.2\% - 0.8\% = 0.4\%$

- b. If the Bank A can only receive 1,150 million (50 million overdue), the real average lending rate is:

$$1,150 \text{ million}/100,000 \text{ million} \times 100 = 1.15\%$$

Then the difference between rates is:

$$1.15\% - 0.8\% = 0.35\%$$

This example shows that in the case (a), the Bank A doesn't observe the regulation on the difference between rates (0.4% is higher than 0.35%), but in the case (b) it succeeds in ensuring the difference as required. But in fact, in the case (b) the bank's credit quality is bad. Apparently, the difference between

rates doesn't reflect anything. It fails to encourage banks to keep its bad debts low, moreover this regulation backfires on the banking system when all banks have chances to allow bad debts increase.

Fifthly, the difference of 0.35% gives no protection for depositors.

To protect depositors against banks' insolvency is one of principles of banking business, but this also means paying attention to banks' health and survival. Some people are of the opinion that the regulation on the difference between rates aims at preventing banks from lowering deposit rate, that is, preventing the real lending rate from rising. But thinking through, we saw that the rate of 1.25 was only a ceiling on the lending rate, not a required rate, then when a bank can make use of a source of capital of low interest rate, it can offer a lending rate lower than the rate-ceiling. The bank can only set up an interest rate at its will when it enjoys a monopoly, but in a market with competition, offering a low deposit rate is a suicidal policy, therefore all banks have recently out done each other in raising the deposit rate with a view to attracting call deposits.

4. Should banking authorities set up several differences for different banks?

The answer is "No". If banking authorities set up several differences, they only show that they pay more attention to banks with unfavorable conditions but they can't solve basic problems. As stated above, the difference of 0.35% is unrealistic and fails to reflect banks' loan quality. As for rural banks, even if they are allowed a wider difference between rates, they are forced to lower the deposit rate because there is a ceiling on the lending rate, so they are put at a disadvantage again.

Therefore, in our opinion, there must be new directions for the task of controlling the interest rate. They are as follows:

- Reducing, and then, removing interest on current accounts.

- Widening the gap between interest rates on short-term deposits and on long-term deposits with a view to expanding the source of long-term capital.

- For the time being, the banking authority had better set up a ceiling on the lending rate and remove the regulation on the difference between rates