PERFECTING THE MECHANISM FOR INTEREST RATE CONTROL IN VIETNAM TODAY

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Interest rate is one of crucial tools for central banks to administer its monetary policy, and has thus far been employed in many countries as an effective economic tool. Particularly in the market economy, it has become a useful tool for the central bank to control inflation and stimulate economic growth. Recently, Vietnam's interest rate has been a matter of concern to many researchers and the public. They were wondering how the interest rate, in the context of high inflation rate, could attract deposits and guarantee the payment ability of borrowers, appropriate costs as well as acceptable profit for commercial banks.

The Vietnam's State Bank Law 2010 has classified the interest rate as a tool for administering monetary policy and preventing usury. The base rate, as prescribed in the law, is based on market supply and demand and then promulgated by the SBV. Additionally, the Vietnam's State Bank Law 2010 also allows the SBV to manipulate the mechanism for controlling the interest rate applied to transactions between banking institutions and between them and customers in case of unusual fluctuations in the money market.

In order to clarify the aforementioned objective of the SBV, the paper will analyze and evaluate its interest rate controlling mechanism as from April 2010 till now, and then recommend some measures to perfect the mechanism.

Keywords: interest rate, interest rate control, monetary policy, inflation, SBV

1. Deposit and lending rates

Following Resolution 23/2008/NQ-QH12 dated Nov. 6, 2008 by the NA concerning the socioeconomic development plan in 2009; Resolutions 12/NQ-CP dated March 7, 2010 and 18/NQ-CP dated April 6, 2010 by the Government; PM instructions in official letter 627/VPCP-KTTH dated Jan. 23, 2009 by the Government Office regarding the application of agreed-upon interest rate to banking institutions; the SBV issued Circular 12/2010/TT-NHNN dated April 14, 2010 permitting banking institutions to lend in VND to customers at agreed-upon interest rates. Accordingly, banking institutions can set the lending rate based on the SBV base rate and apply the agreed-upon interest rate to loans supplied to highly-productive projects according to rules set by Banking Institutions Law, regulations about loan supply, and signs from the market. In sum, the lending rate of banking institutions is liberalized in the hope of making the loan supply by

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commercial banks more transparent, constraining unfair competition, ensuring a real value for interest rate, and lowering the interest rate using competitive forces, thereby helping customers get an easier access to bank loans.

money market. The open-market rate profoundly influences the supply and demand of capital, inter-bank rate, and deposit and lending rates of commercial banks. The refunding rate and overnight rate in the inter-bank electronic

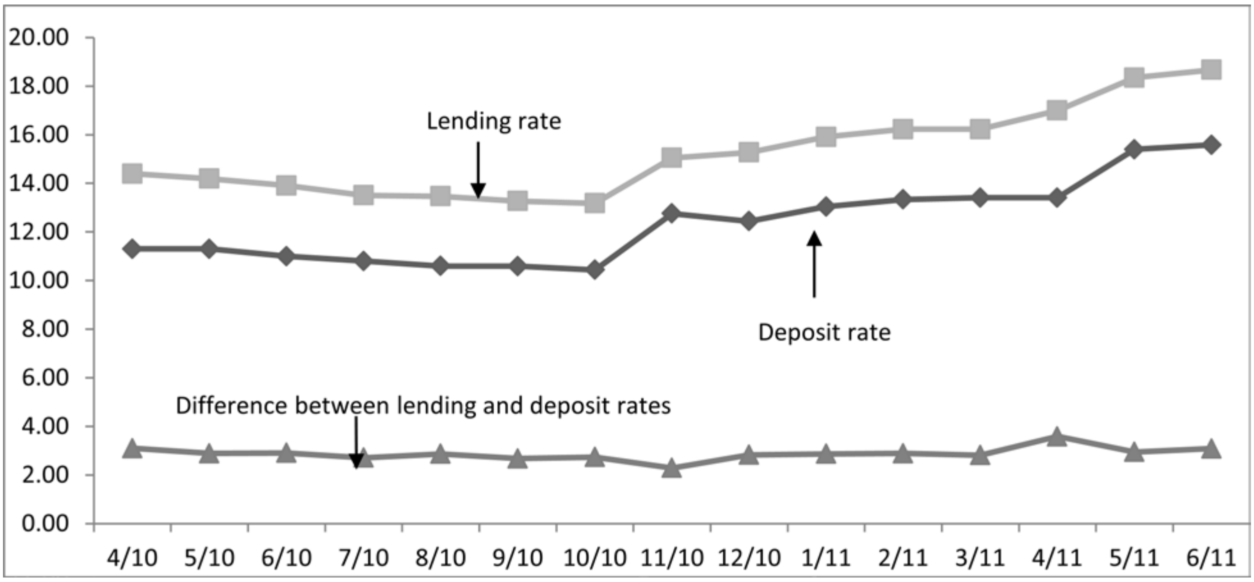

Figure 1: Fluctuations in the borrowing rate and VND lending rate from April 2010 till now

From April 2010 until mid 2011, the deposit rate and lending rate of banking institutions have been on the same trend, and the difference between these two rates is stably maintained at around 2.8 to 4.0 percent per annum. Nonetheless, in practice, such the difference is slightly shortened due to the fact that most banking institutions must pay for sale promotion, marketing, and bonuses much more than expected (i.e. expenses exceed the maximum deposit rate ceiling whereas the lending rate does not rise accordingly). Moreover, interest payment from customers is not as high as expected because economic recession prevented customers from paying interest when due. Although the interest rate goes up, the bank deposit only rises slowly owing to impacts of various factors, such as high inflation, increased gold price, frozen real estate market, and presence of suppliers of informal loans, etc.

Moreover, the SBV keeps manipulating flexibly refunding rate, discount rate, and open-market rate to regulate the interest rate on payment system serves as rate ceilings in the inter-bank market and are flexibly administered in order to ensure the liquidity and enable commercial banks to expand its credit effectively to fields such as agriculture, rural areas, export, and small and medium-sized enterprises. The agreed-upon interest rate enhances the credit quality through selecting effective business projects, and enables banking institutions to mobilize and lend capital.

The application of agreed-upon interest rate will make activities in the finance market more appropriate to the market mechanism. Sections in the finance market are also enabled to link together as per the theory of communicating vessels, making them operate better and compete in a fairer manner; and capital buyers in general can benefit greatly in the medium and long term.

2. Refunding rate and rediscount rate

In order to finance commercial banks and play well the role as the lender of last resort, the SBV refund banks by financing valuable lending contracts signed by commercial banks. In addition, discounting and rediscounting loans are also included in the SBV refunding system. Valuable papers accepted for SBV refunding service include treasury bills and short-term loan deeds, etc. Refunding and rediscount rates are specifically stipulated according to the target of the monetary policy. If inflation is too high, the refunding and rediscount rates can be pushed up to reduce the money supply and control the inflation. During economic recession, they can go down to stimulate economic growth.

In recent years, the interest rate has been kept rather flexible as shown in the following facts:

In the period 2000-2005, the macroeconomic situation was stable; the refunding and rediscount rates were respectively pegged at 6.5% and 4.5% p.a. Yet, in the context of high inflation and trade deficit in 2008, the refunding rate, from 6.5% p.a., rose to 7.5%; 13%, and 15% p.a.; the rediscount rate was also adjusted up to 6%, 11%, and 13% p.a. accordingly.

However, from September 2008 to September 2009, in order to constrain effects of the financial crisis and global economic recession, and secure the macroeconomic stability and social welfare, the SBV did cut down all interest rates. That is, the refunding rate, from 15% fell to 14%, 13%, 12%, 11%, 9.5%, 8%, and 7% p.a. respectively; the rediscount rate, from 13% p.a., plunged to 12%, 11%, 10%, 9%, 7.5%, 6%, and 5% p.a. by the end of 2009.

In 2010, to keep increases in monetary indicators at reasonable levels in order to curb inflation, support the economic growth, secure the liquidity of banking institutions, help banking institutions lower deposit and lending rates, and simultaneously finance the rural and agricultural development, SBV raised all rates: The base rate rose from 8% to 9% p.a.; the refunding rate was adjusted many time, inching from 8% to 11%, 12%, 13% and 14% p.a.; and the rediscount rate edged up 7%, 12% and 13% p.a. accordingly.

Table 1: Fluctuations in SBV interest rates in 2010 – 2011 (% per year)

Date	Base rate	Refunding rate	Rediscount rate
Jan. 1, 2010	8.00	8.00	6.00
Nov. 5, 2010	9.00	9.00	7.00
Feb. 17, 2011	9.00	11.00	7.00
March 8, 2011	9.00	12.00	12.00
April 1, 2011	9.00	13.00	12.00
May 1, 2011	9.00	14.00	13.00

Source: SBV

Refunding and rediscount rates have been two fundamental components of the SBV refunding policy over the past time. They help providing capital for the market as well as the liquidity of banking institutions. However, while SBV can actively control the supply of capital, and it plays a passive role in attracting capital from the market.

Table 1 shows that the base rate was kept stable, whereas the refunding rate and rediscount rate skyrocketed. However, deposits at banking institutions still rose slowly although they continuously raised deposit rate, along with bonuses, from 14% up to 18-19% p.a. By the end of 2010, the bank deposit just increased by 24.5% as compared to the same period of previous year. By late May 2011, the bank deposit rose only 4% and by the end of August 2011 around 8.44% compared to late 2010.

Since September 2011, thanks to adjustments to aforementioned interest rates and strict control over maximum borrowing rate ceiling of 14% p.a. on banking institutions, the VND deposit rate has been kept stable at 14% p.a. at most, and lending rate has gradually fallen to between 17 and 20 percent annually.

3. Overnight rate

In 2002, SBV introduced a new banking tool, the overnight rate, which was at first pegged at 10.8% p.a. In 2008 and 2009, this rate was adjusted down. Yet in the following years, in order to tighten monetary policies, it has been raised many times to 8, 9, 11, 12, 13 and 14 percent per annum, respectively.

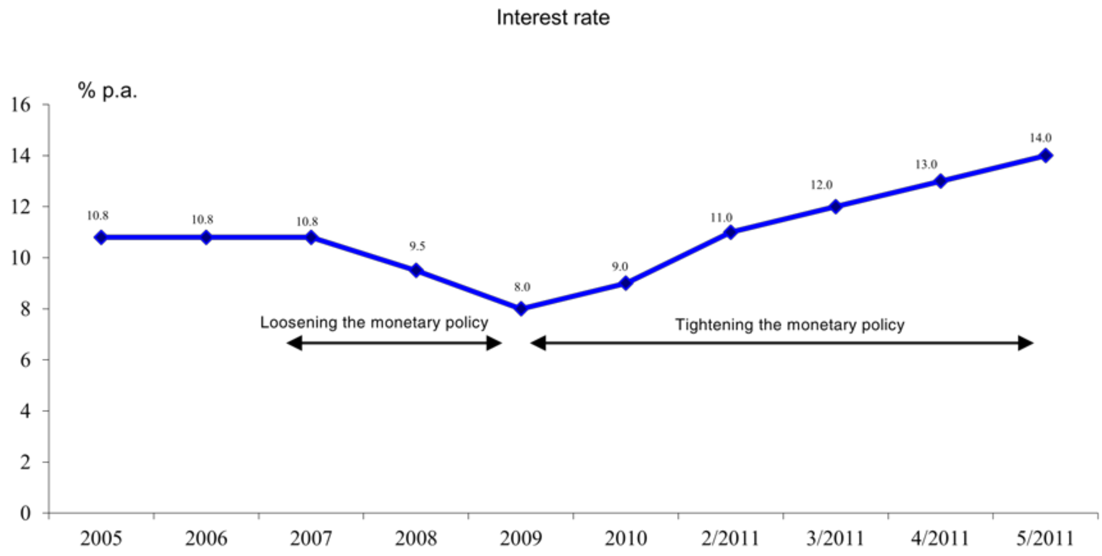

Figure 2: Fluctuations in the overnight rate in the period 2005 – 2011

The overnight rate, which is mentioned above and illustrated in Figure 2, is set by the state bank. Nonetheless, the actual overnight rate between commercial banks is always higher than the SBV rate because banks often negotiate the rate without rendering a report to SBV, and thus SBV cannot control or keep a close watch on such transactions. However, the overnight rate illuminates the two phases of loosening and tightening the monetary policy.

4. Reining in the VND and USD deposit rate ceiling

In order to stabilize the money market, curb inflation, and prevent commercial banks from competing against one another by increasing the deposit rate, the SBV fixes the VND deposit rate, including expenses on sale promotion of any kind, at 14% p.a. at most (Circular 02/2011/TT-NHNN dated March 3, 2011).

Additionally, the USD deposit rate in the domestic market is much higher than the same rates in the world market (i.e. SIBOR and LIBOR) and in neighboring countries (Thailand, Indonesia, Cambodia, Laos and China), and the deposit rate paid by foreign banks to local banks. Such a high USD deposit rate is not reasonable, causing pressure on the rise in VND deposit rate and USD lending rate. In order to keep the local USD deposit rate in line with the foreign one and stabilize the forex and money market as well as attract foreign currencies to Vietnam, the SBV has fixed the maximum USD deposit rate at 0.5% p.a. for residence and non-residence organizations (not including banking institutions), and 2.0% p.a. for all residence and non-residence individuals (Circular 09/2011/TT-NHNN dated April 9, 2011).

5. Evaluating the SBV interest rate control

a. Achievements:

The SBV has controlled volatility in the money market and risks of insolvency in commercial banks (especially small-sized commercial banks developed from rural banks), secured the safe operations of the banking system, and strengthened the consumer confidence in the banking system. Since June 2008 till now, the money market has step by step been stabilized; and the deposit and lending rates have been reasonably adjusted, meeting the capital supply and demand in the local market and macroeconomic factors. Accordingly, enterprises and households are enabled to access bank loans, and the economic recession as a result of the world financial crisis is also weathered.

The transmission mechanism of SBV interest rate policies is really effective and works well with operations of commercial banks. This is evident in the fact that the inter-bank rate only varies between the refunding rate and the rediscount rate; the deposit and lending rate of commercial banks fluctuates according to changes in supply and demand and ranges in line with the SBV interest rates. SBV efforts have forced commercial banks, especially those pursuing a rapid growth in size, to adjust their targets and mode of business by stringently controlling their size and credit quality, and loans supplied to investors in real estate and stock markets in particular.

The base rate is not only a tool to regulate the market but also a channel to broadcast the government's policy. SBV decisions to loosen or tighten the monetary policy have become crucial signals in the financial market. It has been inspected, analyzed and predicted by the public, enterprises, banking institutions, and local and foreign investors who promptly reacted to any changes in the base rate.

The foreign currency interest rate has been basically liberalized, and the mechanism for interest rates in domestic currency also follows the same direction. Vietnam's money market has integrated closer to the regional and international ones. Once the foreign currency deposit rate goes up in foreign markets and demand for bank loans in the domestic market falls, banking institutions mobilize deposits in foreign exchange and deposit them with foreign banks, thereby increasing benefits for depositors, the country and the institution itself. However, once the interest rate plummets, deposits in foreign banks will be withdrawn to invest in the local market.

Banking institutions are freer, more dynamic and flexible in deciding their lending and deposit rates based on market fluctuations and effects of SBV operations.

The circulation of capital in the economy and among regions and industries is promoted by attracting more deposits to the banking system and investing more effectively for the sake of customers. The interest rate really affects decisions and relations (e.g. accumulation – consumption, saving – investment, etc.) of entities in the society.

In transactions between customers and banking institutions, the fairness, equality, and mutual consent on the deposit rate and lending rate are always highly appreciated.

b. Some drawbacks:

The SBV has publicized various interest rates (i.e. base rate, refunding rate, overnight rate, and deposit rate for banking institutions in SBV) to give signals and control interest rates in the money market. Although the function of such interest rates is different, they are partly overlapped and cannot manipulate the market rate which sometimes has the reverse effect to the official interest rates. In other words, official rates are usually adjusted by market rates.

The relation between interest rates in the money market and official ones by the state bank is not close enough. The adjustment function of refunding rates, rediscount, and open market has been limited. The SBV has been forced to employ various tools of the monetary policy, even requesting commercial banks to constrain credit growth and discussing the deposit rate ceiling, in order to stabilize market rates.

The SBV faces some difficulties in manipulating the market rate because the market rate is affected by many factors that the SBV cannot control such as the poor financial resources of banking institutions, fluctuations in the world market, and upheavals in supply of and demand for capital, etc.

The inter-bank rate cannot precisely reflect the relationship between supply and demand in the capital market due to the fact that the lending and borrowing is unidirectional from state-run commercial banks as the lender with abundant sources of capital to branches of foreign banks and joint-stock banks.

Effects of the refunding rate on the monetary policy are constrained because the government restricts the annual supply of money used for increasing bank credits when its main target is to curb the inflation.

The transmission mechanism of official rates is quite weak and tardy, thus effects on saving, spending, investment, aggregate demand, inflation control and economic growth are limited. This is evident in various facts, such as (1) interest rates in the money market is less sensitive to official ones and so are prices of financial asset; (2) the falling exchange rate is kept within bands on either side of the official rate and affected mainly by the supply of and demand for foreign currencies rather than by official interest rates; and (3) the expectation of banking institutions and the public, although affected by SBV adjustments to interest rates, is quite poor.

Impacts of interest rate control mechanism are weak, basically signaling “loosening” or “tightening” direction, and cannot regulate the inter-bank rate and the money market rate.

6. Causes for such drawbacks

a. Objective causes:

Vietnam is a small open economy with a poor competitiveness, thus its finance-money market is very vulnerable to volatility in the world finance market (e.g. world financial crisis, and fluctuations in the world market rate, etc.)

As prescribed in the Law on State Bank, monetary policy and interest rate policy pursue multiple goals which are not homogeneous. For example, SBV has to increase interest rates and reduce the money supply in order to curb inflation, but this effort does not facilitate the credit expansion for economic growth. Therefore, selecting and manipulating a reasonable interest rate mechanism become very difficult, complicated, and less flexible.

Knowledge of the public and companies about monetary policy and interest rate policy is still limited while the interest rate controlling mechanism is complicated, which made it difficult to achieve the public agreement and support for targets of the interest rate policy, and sometimes might produce opposite effects.

The economy contains lots of potential risks and inflation shows an onward trend, causing interest rate to soar. Yet, monetary factors are not its original excuse; and thus the SBV is exposed to hardships in controlling the market rate.

Dollarization is at a quite high rate (foreign deposits/M2 = 16.7%) causing the market rate to be affected not only by the supply-demand relationship but also by the exchange rate. The world market rate and upheavals in the foreign exchange market also sharply impinge on the money market interest rate.

Due to the fact that there is also a great lag time in administering tools of the monetary policy (such as the required reserves, bands on either side of exchange rate, and open market operation, etc.), SBV cannot catch up with practical fluctuations in interest rates and disposable capital of commercial banks. Policy tools are not sensitive to the money market, and thus cannot have great effects, and the perfection of agreed-upon interest rate mechanism is hindered.

The world money market is disrupted and contains numerous risks, and interest rates widely fluctuate, adversely affecting the local market rate. Moreover, capital-related transactions are gradually liberalized, causing difficulties in controlling flows of capital and regulating the market rate.

b. Subjective causes:

SBV has not operated proactively and independently in administering the monetary policy. Under the current mechanism, it is a governmental agency that is directly controlled by the government. Yet the government's deep intervention in the money market and banking system will definitely reduce the independence and dynamism of the SBV. Hence, SBV decisions to administer the money market are not swift, reducing the effectiveness of the monetary policy.

Collaboration between SBV and Ministry of Finance in implementing the interest rate policy, stabilizing the market rate and facilitating the governance of monetary policies is poor. This is evident in the fact that the interest rate of treasury bills and bonds fiercely competes with that of commercial banks, and thus the interest rates cannot clearly reflect the relationship between capital supply and demand.

SBV cannot accurately forecast fluctuations in the supply and demand on the capital market as well as the consumer price index, and thus the planning of monetary policy and interest rate policy is often disrupted.

The combination of the policy on exchange rate and forex management with the interest rate policy has not generated any mutual and positive effects. Goals of those two policies have no relation, and sometimes contradictory.

SBV has not been reasonably restructured according to the request and restructuring process of commercial banks. The restructuring of SBV is to avoid overlap among departments and enhance its effective operation. Accordingly, SBV can observe the volume of disposable capital of banking institutions and become more flexible in employing open market operations and other tools of the monetary policy to directly affect the market rate.

7. Measures to perfect the SBV interest rate controlling mechanism

Firstly, it is necessary to formulate an interest rate controlling mechanism comprising all SBV interest rates (i.e. rediscount rate, refunding rate, open market operation rate, etc.) to ensure that they are totally based on capital supply and demand. Perfecting these interest rates can help the money market operate more frequently and effectively supporting open market operation, inter-bank market, rediscount loans, and refunding loans, etc.

Secondly, in order to enhance the transmission power of the monetary policy, it is crucial to develop the money market. Although Vietnam's money market has existed for years, it has not well developed. The inter-bank market for foreign and domestic currencies is the only place for commercial banks to take out a loan. Lending by SBV in the form of refunding, open market operation, foreign currency swap, and sale and purchase of short-term valuable papers aims at supplying short-term disposable capital in VND to banks. The development of money market is to make the aforementioned SBV operations more flexible and perfect, enable all banking institutions to take part in lending channels and SBV credit activities, and simultaneously guarantee smooth operations of the inter-bank market.

Thirdly, SBV should immediately perfect the agreed-upon interest rate regime and develop the inter-bank market in which SBV must play well its role as the lender of last resort. Additionally, SBV needs to develop the forex market by turning the foreign currency lending regime into the foreign currency buying and selling practices, and increase foreign exchange reserves through the open market operation (i.e. SBV should actively buy foreign currency when necessary).

Fourthly, SBV should quickly improve tools of the monetary policy (e.g. open market operation, refunding loans, rediscount loans, required reserve ratio, and foreign currency swap, etc.) which directly affect the interest rate; actively, flexibly and punctually intervene in the inter-bank market; and soon establish overnight deposit service for banking institutions in the SBV.

Fifthly, predicting macroeconomic matters in general and fluctuations in the money market and disposable capital of banking institutions in particular must be improved. This is supposed to be a vital part in planning and administering short and long-term monetary policies effectively. Econometric models can be employed to facilitate the analysis, prediction and establishment of monetary policies.

Sixthly, banking institutions need to strongly control overheads and minimize direct and indirect costs so as to reduce the lending rate for the sake of customers.

Seventhly, SBV should examine components of input costs and input interest rates of commercial banks such as the required reserve ratio, and the ratio of deposits from the treasury for lending, etc. so as to reduce the lending rate for the sake of customers.

Eighthly, SBV should be restructured so as to avoid overlap in terms of function and duty of each department, improve the competence of all SBV departments, and modernize banking technologies and facilities. It is also advised to guarantee the independence of SBV in administering the monetary policy, and assure the close collaboration between SBV and Ministry of Finance in controlling the interest rate regime and monetary policy in generally.

In the context of a transition economy and closer integration into the world economy, it is really challenging to effectively administer the interest rate regime, and achieve macroeconomic targets. Thus, it requires a synchronous combination with other tools of the monetary policy■

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