Four Years After the Liberation of Interest Rate

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1. Achievements

Although the economic growth in the past few years are not determined totally by the interest rate policy, it still has remarkable effects on the achievements as shown in the following analyses.

a. Development of economic concerns: An interest rate that is lower than the profitability ratio can encourage establishment of new economic concerns, which means a higher economic growth rate. In addition, equal rates for both public and non-public sectors can make private investors feel more confident in the business climate, which affects their decisions to start and develop new enterprises.

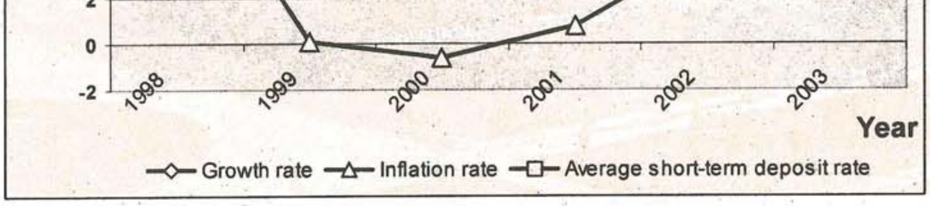
The interest rate policy in the past few years has produced such effects. The number of new concerns increased by 238% in 2000-05, the total private investment reached VND193,500 billion, that is, 1,688 concerns came into being every month in this period. Moreover, commercial banks and finance companies, encouraged by reasonable interest rates, have expanded their activities and given more support to companies of all sectors. This is shown in the following figure.

b. Higher saving and investment ratio: The interest rate policy has encouraged both bank deposit and lending when the public felt confident in the banking system. The bank deposit increased steadily in the past few years. Deposits from individuals represented 50% of the total deposit. Medium- term capital, one- or two-year maturity, increased well while the long-term one was still small (4% of the total medium- and long-term capital). In 2005, commercial banks planned to offer a more attractive interest rate in order to mobilize more idle money. Generally, the interest rate offered privately-run banks is slightly higher than one offered by state-owned banks.

Bank deposits and lending in foreign exchange also increased by 750% in the years 1995-2004, which reflected development of the foreign trade. In the first seven months of 2005 when the interest rate in the dollar rose against the one in the VND, flows of deposits in the domestic currency was stable while the bank deposit in foreign exchange increased faster, 14.28% compared with 12.54%.

With an average growth rate of 7% and one-digit inflation rate, flows of foreign capital into Vietnam also increased and made the gross investment rise. In the years 1995-2004, the bank lending rose by 704%. In 2005, however, the higher interest rate made the supply of credit rise at lower rate compared with previous years. Up to July 2005, the bank lending rose by 12.14% (the growth rate in the first seven months of 2004 was 14.13%): lending in the VND by 11.3% and in the dollar 14.27%.

In addition, the loan quality was also improved. Long- and medium-term loans rose by 35% in 2000 and 40% in 2004 while the proportion of overdue loan fell from 13.7% in 1999 to 6.7% in 2004.



Thus, the interest rate policy has helped increase the saving and investment rates. If commercial banks can adjust their interest rates to changes in the market, they will improve their deposit and lending.

2. Shortcomings

a. The interest rate policy failed to adjust to the inflation rate: The SBV tended to lower the average deposit rate while the inflation rate fluctuated over years, which made the business circle feel doubtful about its ability to adjust the interest rate to changes in the market forces.

b. The policy failed to mobilize all sources of idle money: Since 2004 the SBV has employed flexibly the interest rate but the mobilized capital only rose at 26.8%, a moderate rate, in the years 2000-05. The total bank deposit accounted for only one fourth of the total idle money. The best part of this source is kept by the public in forms of cash, foreign exchange, insurance policies, real estate, etc. The WB estimated that the proportion of bank deposit to the GDP was low in comparison with neighboring countries: some 30% of South Korea's and some 25% of China's. This situation led to low capital accumulation and dependence on external sources. To deal successfully with this problem is no easy task in the coming years.

Up till now, commercial banks usually mobilize the capital through traditional channels. They have recently used new instruments but haven't produced intended results. Payment by check is not as popular as expected and the only way for banks to encourage deposit from the public is to offer more attractive interest rates. This interest rate war puts small-size banks at a disadvantage. The unstable real interest rate makes it difficult for banks to mobilize long-term deposits. In 2005, commercial banks also faced competition from non-banking institutions that are allowed to mobilize idle money from the public (post saving, insurance companies, government and project bills, privatized companies, etc.), which made them fail to increase the bank deposit at higher rates.

c. The policy failed to coordinate with other monetary instruments:

- Required reserve: The reserve ratio has been applied since 1992 but it is only applied to short-term deposits (one with a maturity of 12 months or shorter), which reduces its role in regulating the supply of money. In addition, low interest rate on the reserve couldn't encourage commercial banks to make the best use of deposits with the result that their reserve surplus limits the supply of short-term or overnight loans. Thus, the SBV failed to act as the lender of last resort and it only supplied loans as required by commercial banks without caring about the supply of and demand for the money in the economy.

- Refunding: This service is usually done slowly, and sometimes according to instructions from the government when facing an urgent situation instead of being carried out according to a common mechanism. In addition, the service aims mainly at state-owned banks while most privately-run banks have no conditions for securing it. This practice makes the SBV less effective in regulating the money supply and the interest rate.


Photo by Huỳnh Thơ

- Open market operations: Proportion of total purchase through these operations to total value of refunding by the SBV rose from 45% in 2001 to 75% in 2003 and some 80% in 2004-05 but these operations are not busy as expected because of the limited quantity of commodities and participants mostly state-owned banks). This means that the open market has a limited effect on the disposable capital of commercial banks.

- Exchange rate: The exchange rate and interest rate are allowed to float by degrees. From June 2002 on, the floating interest rate has helped the SBV regulate the market rate through its monetary instruments; and the flexible exchange rate helped promote export; limit import and improve the balance of payments. Under this mechanism, the SBV sometimes intervenes in order to regulate the exchange rate if need be. This means that the liberated interest rate is not coordinated with the flexible exchange rate, which produces chance to the trade in currencies. Commercial banks can make huge profit when there is a remarkable difference between interests on loans in the dollar and the domestic currency while the exchange rate stays unchanged.

d. The interest rate policy isn't linked with operations of the stock market: In five years after its establishment, stock trading centers in Vietnam has made some progress. At present, total value of listed stocks equals some 1.9% of the GDP, a very small percentage. This means that the stock market couldn't be a channel for long- and medium–term capital. There is no relation between changes in prices of stocks and interest rate. Prices of stocks have experienced wide fluctuations although the interest rate is rather stable.

e. Unreasonable relation between various kinds of interest rates: At present, the SBV employs basic rate, discount rate, refunding rate and open market rate to implement its monetary policy. Relations between these rates imply unreasonable aspects:

- The basic rate is adjusted to changes in the market but the adjustment is usually smaller than fluctuation in the market rate.

- The interest rate on short-term deposit set below the rate awarded during auctions of T-bills is unreasonable because this situation failed to encourage commercial banks to invest in this kind of commodity. The interest rate of T-bills is usually considered as the lowest and standard rate in the money market but in fact, this rate is usually equal to, or higher than, rates offered by commercial banks. Thus the standard rate hasn't come into being in the money market.

- The VNIBOR rate fails to reflect the supply of and demand for short-term capital, so it couldn't be a rate of reference because many banks didn't take part regularly in the market and there is no mechanism for imposing responsibility on banks engaging in the market.

In short, the SBV intervention in the interest rate seems to produce no effect on the market rate. Small changes in the interest rate couldn't affect deposit and lending rate offered by banks. Moreover, the limit on the interest rate set by the SBV prevents the interest rate from adjusting itself to fluctuations in the market forces.■