COULD A LOWER LOAN RATE CEILING STIMULATE THE ECONOMIC GROWTH?

by Dr. NGUYỄN ĐẮC HƯNG

At present, there is a division of opinion in the business circle: one advises lowering the loan rate ceiling in order to stimulate the economic growth; and another is against it by maintaining that this solution could cause harm to financial position of banks and difficulties in attracting deposits. Which solution should we choose?

Interest rate and exchange rate are two important instruments of monetary policy used by the government to control the level of economic activity. After the financial crisis broke out in Southeast Asia in late 1997, central banks all over the world decided to raise their loan rates. In certain countries and territories, such as Thailand, Indonesia, Malaysia and Hongkong, the loan rate increased by some two times. Increasing the loan rate in an effort to fight against depreciation of domestic currency and speculation in foreign currencies using bank loans in domestic currency proved to be an effective measure to survive the global financial crisis. From 1998 on, when disastrous consequences of the crisis were partly repaired, banking authorities in many countries started to cut the loan rate to make the economy grow faster. Recent statistics show that from 1998 till now, there have been 108 cuts in loan rate and their stimulating effects have made their appearance. This measure has been adopted by even economic powers such as the U.S., Canada, Japan, Australia and the EU. The Federal Reserve Bank has made three cuts in discount rate within eight months and the effect is now so obvious that many people believe that the American economy will make a record success by growing steadily in nine years in a row if the situation keeps going on like this for another eight months. On May 3,1999, the DJAI reached 11,000, a record high. In April, IMF experts stopped their warning about a global depression and predicted that the world economy would recover remarkably next year and this result was mainly due to efforts made by governments to regulate the interest rate.

On April 8,1999, the European Central Bank (ECB) reduced its base discount rate from 3% to 2.5%, interest rate charged on member banks for loans from 4.5% to 3.5% and overnight rate from 2% to 1.5%.

An analysis presented by the State Bank of Vietnam's (SBV) Policy Department said that the ECB's decision led to a series of cuts in European lending rate. Also on April 8, the Bank of England declared that the Overnight Repo would be reduced from 5.5% to 5.25%. The U.K. monetary authorities said that cuts in loan rate were introduced on condition that the inflation rate was too low and unemployment rate was too high. This was the sixth cut taken by the Bank of England since November 1998 and also the biggest one. Following in footsteps of these two banks, the Bank of Switzerland also reduced its base discount rate from 1% to 0.5% and the Bank of Czech reduced the interest rate from 7.5% to 7.2%.

The ECB decision on cut in discount rate was applied, after it was publicized, to all 11 countries in the Euro area. The decision is based on a prediction of a fall in growth rates of European economies in 1999 when the general inflation rate remains unchanged.

The Malaysian central bank also implemented an appropriate policy on interest rate this year with a view to recovering the economy and adjusting to changes in the region. On April 6,1999, the Malaysian central bank took a further cut in the interest rate and more interventions in the inter-bank market providing a basis for commercial banks to reduce their lending rate from 7% to 6.5%.

Vietnam didn't fall into a financial crisis but its economy was affected considerably by the Asian crisis. In 1998, its growth rate, export earnings and foreign investment were all on the decrease. In the first months of 1999, according to a report of the Government to the National Assembly, the growth rate in the first quarter was 4%, compared with 5.8% in the same period last year, industrial output grew by 10.3% (the lowest level in the past few years), export decreased by 10% and foreign investment by some 50%. The report also predicted that the situation would go from bad to worse next quarter.

Facing such a situation, many experts, policy-makers and businesspersons think that banking authorities should lower the lending rate. Certain officials from the Ministry of Finance also supported this opinion. This group believed that a cut in the interest rate was one of the best measures to save Vietnam from effects of the Asian financial crisis and a lower loan rate would be of great importance to the policy on domestic investment and production.

Many petitions presented by businesspersons argued that most local companies, both state-run and private ones, had to depend on banks for working capital; the current interest rate varies from 13.2% to 15% which is much higher than interest rate found in neighboring countries and higher than the general profitability ratio (which is only 5% or 6% a year), therefore all producers couldn't gain enough profit to pay bank interest.

This opinion forces us to review the implementation of monetary policy in the past two years.

During and after the financial crisis from 1998 till now, the SBV has made two adjustments to the loan rate ceiling: Decision 39/1998/QĐ- NHNN made by the SBV Governor on Jan.17,1998 ruling that as from Jan.21,1998, the interest rate for short-term loan in VND was increased from 1% to 1.20% per month; for medium- and long-term loan: from 1.1% to 1.25% per month.

One year after, the Governor issued Directive 01/1999/CT-NHNN1 on Jan.29,1999 ruling that as from Feb.1,1999, the lending rate ceiling for short-term loans supplied by four state-run commercial banks to the city would be reduced to 1.1% a month; for medium- and long-term loans: to 1.15% a month; for loans supplied by joint stock banking institutions and loans supplied to rural residents would stay at 1.2% a month.

On Feb.10,1999, the Governor issued Decision 52/1999/QĐ-NHNN1 setting reserve requirements. According to this Decision, the required reserve ratio for call deposits and under-12-month fixed deposits placed with banking institutions in cities is 7%; and 5% if they are placed with rural joint stock commercial banks, Central and Local Credit Funds; and 0% for over-12-month deposits. The required reserve ratio is thus lower than the ratio of 10% set by Decision 135/QĐ-NHNN1 on April 11,1998. This means a cut in the lending rate to banking institutions.

Generally, the loan rate ceiling accoring to regulations set by the SBV didn't reduce because all current rates are higher than those applied before June 30,1997 when the financial crisis broke out in Thailand. In addition, the Official Letter 313/CV-NHNN from the SBV said that many banking institutions, especially those operating in rural areas, didn't observe the regulation on the loan rate ceiling. Some of them even demanded from borrowers a fee as a percentage of the loan supplied. This practice, in fact, was a way to raise the lending rate.

Thus, the opinion approving a lower loan rate has its sound arguments. It is appropriate to the common trend in the world economy and changes in interest rates in Vietnam. But what problems will arise from a lower loan rate?

As everybody knows, adjustments to the interest rate will affect directly all depositors, borrowers and financial intermediaries. As for banking institutions, a lower loan rate means reducing the deposit rate, but the better part of their working capital came from deposits placed with them in the past when the interest rate was high. Therefore, the interest rate margin be-came smaller bringing banking institutions to financial difficulties.

According to Decision 48/QĐ-NHNN5/1999 made by the SBV Governor on Feb.8, 1999, all banking institutions, within 25 days after this Decision comes into effect (that is, in early March 1999), should form reserve funds for banking risk. There are four levels of percentage set aside according to value of different kinds of secured overdue debt: over 360 days, over 180 days, over 90 days and under 90 days overdue; revenues from discounting eligible papers which are under 30 days overdue; payments according to guarantee agreements but they aren't refunded within 30 days, etc. The amounts set aside are turned into bank overheads. Thus, if we suppose that a commercial bank has total outstanding loan of 27,000 billion on Dec.31,1998, 4% of it (or 1,081 billion) is overdue, and suppose that all loans are secured ones. Those overdue debts, of course, accumulated over time and amounts set aside for reserve were of different percentages. But the percentage, in round figure, is estimated at 40%, and thus, there should be 432 billion in its reserve fund and this amount should be included in the bank's overheads in 1998. However, the bank didn't provide for such a large sum of money in its reserve fund, so this problem becomes too difficult to solve and the bank's financial situation goes from bad to worse. In addition, the bank should form the reserve fund for interest rate risk in 1999. If the loan rate ceiling is lowered as suggested, then the bank should lower the deposit rate and this deed will affect greatly millions of depositors.

A lower loan rate can, of course, help banks increase amount of loans supplied. However, everything in banking business isn't so simple because it depends on many other factors (borrowers' creditworthiness for example), so increases in the amount of loan supplied can lead to increases in doubtful debts.

As for depositors, a lower interest rate means a smaller income. They certainly think that this policy will cause their savings to contract because the interest rate isn't higher than the inflation rate. In fact, the highest interest rate the bank can offer now is only 1% a month and the average deposit rate is 0.6%- 0.7% a month, or 7.2 – 8.5% a year, while the inflation rate in 1998 was 9.2%.

Thus, as presented above, if the loan rate ceiling is reduced to the level applied before July 1997 (1% a month for short-term loans and 1.1% for medium- and long-term ones) the deposit rate will be reduced to 0.5% or 0.6% a month, while the inflation rate in 1999 is estimated at 10%. So, the deposit rate seems to be lower than the inflation rate.

Adjustments to the interest rate also affect capital accumulation, investment, saving and private spending. Lower deposit rates discourages savers from placing their money with banks and encourages them to spend more. Private spending can, of course, stimulate local production but it will lead to a shortage of capital because bank deposit will certainly decrease.

Meanwhile, the PM, in his Decision 13/1999 ordered the Post and Telecommunications Corporation to mobilize some VND 1,500 billion in 1999 while the Vietnam Bank for Development and Investment has finished mobilizing 1,400 billion (including US$30 million) by issuing bonds at a high discount and the General Department of Development and Investment also mobilized VND400 billion. Thus, the banking system will meet with great competition in attracting dead money.

When the loan rate is reduced, the deposit rate will be reduced accordingly but will the discount offered by T-bills be reduced? If not, the monetary policy couldn't be implemented consistently. If T-bills are sold at a lower discount, the capital needed for government investment won't be ensured and this produce bad effects on the economic development.

Many people are wondering why the Vietnam Bank for Development and Investment is allowed to mobilize over VND1,000 billion by offering a high interest rate (over 1% a month). The answer given by experts is very simple: the Decision 13/1999 by the PM ordered this bank to mobilize enough capital to serve the plan to cover VND400 billion worth of government credit.

Other people wonder why deposits in many commercial banks kept on increasing in the past few months regardless of the fact that the deposit rate has been reduced. However, the interest rate at that time was reduced by only 0.1% - 0.15%. If it is reduced by 0.15% or 0.25% more as planned, it will be easier to predict further difficulties in attracting more deposit.

What will happen to borrowers? It would be an exaggeration to say a fall in interest rate is a lifebuoy for local companies, because a low lending rate is only an important, not decisive, factor in their development. If the interest rate is reduced but the system of state-run companies isn't reformed and these companies fail to improve their managerial skills; know-how, business strategies and labor productivity, they won't be able to employ any source of capital, even interest-free one, and investment from banks couldn't produce intended results. That is why great importance is attached to the reform and upgrading of companies' managerial skills and business performance. It's reasonable that all borrowers have to service their debts and the Government couldn't give subsidies to help state-companies pay interest on their debts. But it seems to us that all companies, when complaining about the shortage of capital, are only badly in need of interest-free or soft loans. If the interest rate is reduced without reforming radically the system of state-run companies, the repayment risk seems to become more serious and banks will suffer huge overdue debts.

As for some four million farmer families who have to depend on banks for capital and pay a higher interest rate on bank loans than what state-run companies and townsfolk do, a lower loan rate will be of great benefit to them and active effects on agricultural production are obvious. So if the interest rate is to be reduced, it should be done firstly in rural areas in order to ensure equal treatment to all customers of the banking system.

A cheap money policy can certainly help create more jobs and stimulate the economic growth, but on the other hand, it can cause the inflation rate to rise. In implementing the cheap money policy, lowering the lending rate and discount rate, reducing the reserve requirement, loosening the credit control and restrictions on supply of credit, etc. are necessary but it also requires many controlling and regulating measures. Any monetary policy has its own positive effects and all negative ones should be anticipated and predicted based on scientific grounds■