ON NEGATIVE EFFECTS CAUSED BY A REDUCTION IN INTEREST RATE

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After the right policy on exempting bank credit service from turnover tax has come into effect for six months, we could review the way we reduced the interest rate. The overall impression was that a right policy could produce harmful side-effects instead of intended results because wrong measures were taken to carry it out.

The first lesson from this fact is that it's necessary to study suggestions made by economists coping with potential dangers discussed by the press or professional conferences. In 1994, the conference of bankers discussed and decided on a reduction in interest rate and there were many articles warning of danger caused by a high interest rate. In the middle of the year, when the inflation rate tended to reach two-digit level, the State Bank suddenly stopped to mention the reduction in interest rate. At the beginning of 1995, at a meeting of the PM and business circle, when this problem was repeated, the PM said that he approved of reducing interest rate but wondered how to do it.

Thus the PM understood that the way of doing things was a matter of great importance and the bankers would have discussed measures to reduce it. Many people regretted that if the difference between interest rates paid on 3 - month deposits (16.8%) and that paid on 12-month deposits (24%) had been reduced, many commercial banks would not have suffered losses because of the sudden reduction in interest rate.

Some experts from the State Bank argued loss suffered for the failure of commercial banks to lower the borrowing rate in October 1995 when the National Assembly decided on exempting bank credit service from turnover tax with a view to reducing interest rate. But as we know, 49.9% of members of the National Assembly thought that exemption from turnover tax benefited only the banking system instead of the economy as a whole so they voted against it. Therefore no commercial bank dared lower the borrowing rate because all customers would withdraw their deposits from this bank. Even in the conference on exemption from turnover tax, there were too many opinions suggesting lowering lending rate after the turnover tax was exempted, and there was only one opinion about lowering interest paid on 6-and 12-month deposits.

The second lesson is that full attention must be given to the relation between borrowing and lending rates.

Because no attention was given to the opinion about lowering interest paid on fixed deposits, experts from the Vietnam State Bank had insisted on the difference of 0.35% between the borrowing and lending rates. This difference was taken from foreign experience and submitted to the Government.

In fact, high interest rate paid on fixed deposist forced commercial banks to charge a lending rate of 30% on their customers in 1995 so it was a terrible shock to them when the lending rate was reduced by 9%, from 30% to 21%, in one day only (Jan.1,1996). At present in fact, commercial banks have to pay interest rates varying from 1.35% to 1.5% to fixed deposits, and they have to suffer losses when they could only charge an interest rate of 1.75% of their debtors. Actually, 9 HCMC-based banks have suffered losses since April 1996.

The third lesson, even small mistakes in calculation are unacceptable.

With the allowed difference of 0.35%, how can a commercial bank make a profit? The following are its calculations:

- If bank deposits amount to 1,000 billion, the bank will pay 14 billion in interest (1.4% of 1,000 billion, because 1.75% minus 0.35% equals 1.4%).
- The bank can only lend 80% of bank deposits and gain total interest of 800 billion x 1.75% = 14 billion while it has to pay running cost of 3 billion (0.3% of 1,000 billion).

To make a profit, the bank has to reduce the borrowing rate to under 1.1%.

A high-ranking official in the Vietnam State Bank disagreed with this and argued that: "the bank pays only 800 billion x 1.4% = 11.2 billion