ON VIETNAMESE CENTRAL BANK'S INTEREST RATE POLICY

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On the financial market, interest rates are seen as prices of credit. Interest rates are very sensible to the capital supply and demand relations. When there is an imbalance in these relations, the redistribution of income between lenders and borrowers will occur through a rise or drop in interest rates. This characteristic of interest rates affects the distribution of social finance in the relation between saving and investment. In the short term, higher interest rates will encourage people to limit their spending at present in order to increase saving ratio of their income. Later, from this saving, they will choose to invest in financial activities when seeing it more beneficial. On the contrary, higher interest rates will hamper enterprises' taking loans for investment because the income earned from investment projects can hardly cover the loan interest. If this situation prolongs, the social investment will decline.

The result is that the GDP grows slowly, the per capita income is not improved and the future saving will go down. As such, to generate positive effects on long-term capital mobilization, the economy cannot accept too high interest rates. Holding low interest rates, but securing the principle of positive real interest rates and including the supply and demand relation , inflation, and economic efficiency will produce multidirectional effects on saving and investment. Positive real interest rates will help the economy remove the pressure of increasing inflation and enhance the saving motivation because it deletes bad impacts on saving. Low interest rates will encourage enterprises to promote their borrowing for expanded investment, thus spurring economic growth and personal income, and improving saving in the future.

On the other hand, in the open economy, interest rates have a certain effect on changes in the relation of foreign currency supply and demand, so it will contribute to the volatility in exchange rate and balance of payments. When the interest rates change for the purpose of controlling and curbing the deficit in balance of payments, it will affect positively the total saving and income. Because to control the balance of payments means to hold on factors that lead to excessive spending of the public and private sectors on imported goods; therefore, the motivation of saving and investment will be fortified.

As such, the above analysis indicates that interest rates affect the process of capital mobilization for the economy. It contains economic connections among depositors, borrowers and credit institutions. In the macroeconomic aspect, interest rates are an instrument to implement the monetary policy. In principle, the macroeconomic and microeconomic benefits must be integrated in the State Bank of Vietnam (SBV)'s interest rate policy with a view to generating development dynamic. Nevertheless, the above theory can come true only when interest rates are liberalized and the SBV has full autonomy in interest rates management with the aim to stabilize prices at reasonable inflation rate but not causing a decline in growth and employment.

1.Facts and figures

In the early years of the *đổi mới* period, the Government has concentrated its efforts on establishing necessary grounds for the implementation of policy on market interest rates. In fact, when the Ordinance on the State Bank, Ordinance on Commercial Banks, financial companies and credit cooperatives are promulgated in May 1990, the Vietnam's banking system is organized into two levels. To function administration, the SBV has step by step changed its policy on negative interest rates to positive ones and apply it to all economic sectors. Accordingly, from 1996 until now, the SBV's interest rate policy has shifted to liberalization as follows:

- Thanks to significant achievements recorded in the 1991-1995 period, the SBV changed interest rates towards liberalization by Decision 38 QĐ/NH1 dated December 28, 1995 and following decisions: 191/QĐ-NH1, 225/QĐ-NH1, 226/QĐ-NH2:

+ The policy secures medium- and long-term loan interest rates are higher than the short-term ones. This is a positive move in accordance with the principle of setting interest rates and encouraging credit institutions to attract and lend medium- and long-term funds for development investment in the national industrialization.

+ It also cancelled the rule on controlling floor interest rates for deposits and announced the ceiling interest rates for loans. Based on the ceiling loan interest rates and the difference between loan interest rates and deposit interest rates permitted at 0.35% per month, credit institutions set the deposit and loan interest rates on the market.

In 1997 and 1998 the regional financial crisis affected the foreign exchange rate and money circulation in the country, forcing credit institutions to increase the deposit interest rates. At the same time, the loan interest rates were steadily on the drop to boost lending in accordance with the enterprise's capital absorbability and business performance. The difference between loan interest rates and deposit interest rates plunged dramatically because of this trend. Although the National Assembly allowed the difference of 0.35% per month (4.2% per year), just a few banks reached this figure. The evidence indicated the interest rates difference set at 0.35%/month was not practically significant. In the first quarter of 1998, the National Assembly cancelled the difference between loan and deposit interest rates to make interest rate policy more flexible.

In 1999, the SBV had to lower continuously the ceiling loan interest rates of credit institutions because the economy hit deflation. In such a situation, the interest rate cut-off was aimed at improving the role of positive interest rates, stimulating the demand for spending and investment, spurring economic growth and at the same time bringing local interest rates close to those in the regional and international financial markets and filling the gap between local and foreign currency interest rates.

- By 2000, to reform interest rate policy and mechanism in compliance with the Law on the State Bank, the SBV issued Decision 241/2000 on August 2, 2000 to replace the management mechanism based on ceiling loan interest rates with that on the basic interest rate. Under this mechanism, the SBV did not announce the deposit interest rate, but loan interest rates in Vietnamese đồng. The SBV announces the basic interest rate based on short-term loan interest rates for the best client of a group of credit institutions selected in each period. Accordingly, credit institutions are allowed to set the trading interest rates which must not exceed the basic interest rate and the permitted trading band. Regarding interest rates of loans in foreign currency, credit institutions are entitled to set the loan interest rates which must not exceed the Singapore Interbank Offered Rate (SIBOR) for three-month loans in US dollar and the trading band permitted by the SBV.

Nevertheless, in the trend of regional countries fully liberalizing their interest rates of foreign currency loans, to make favorable conditions for mobilizing foreign capital sources as well as implement the forex control mechanism effectively, by June 2001, the SBV's Decision 718 dated May 29, 2001 gave a green light to credit institutions' right to set US dollar loan interest rates freely based on interest rates of the international market and the supply and demand for credit in foreign currency on the local market. It abolished the rule controlling the loan interest rates by SIBOR and permitted trading band. These reforms reveal the SBV has been determined to renovate its interest rate policy toward liberalization and step by step attach the local interest rates to the regional and the world markets. This is also the first step to make the Vietnam's finance appropriate to the international common practice, and integrate it into the world finance more extensively.

In short, after 10 years of renovation, the Vietnam's interest rates have been increasingly liberalized in accordance with the economic restructuring. It has become an important instrument of the SBV to stabilize the macro-economic environment, and stimulate saving and investment for economic development. This can be proved by increasing deposits, credit restructuring for a multisectoral economy (in 1991 the loans offered to state-owned enterprises (SOEs) accounted for 90% of total outstanding loans of commercial banks, nevertheless, this figure dropped to 48% while the nonstate sector's figure soared from 10% in 1991 to 52% in 1999. The percentage of medium- and long-term loans has been promoted. In 1990 the long-term loans from banks represented 10-15%, but this figure increased to 45% in 1999).

2. Shortcomings

However, the SBV's interest rate policy remains some major shortcomings as follows:

- Although the SBV has liberalized its interest rates for foreign currency, changed into the management mechanism with basic interest rate for local currency, it still set the trading band to control the loan interest rates for local currency. This has hinder the process of liberalization of local currency loan interest rates and led to following deficiencies:

+ The interest rate upheavals in the world financial market will increase risks to the trading in local currency because banks cannot proactively adjust interest rates in local currency.

+ The interest rates cannot cover all currency risks and restrict the banks' autonomy in business. They might have set loan interest rates appropriate to the financial position and creditworthiness of each customer.

+ Such a rule does not create a real competition business environment in accordance with the market mechanism.

- At present, the interest rates on the interbank market have not yet reflected exactly the supply of and demand for disposable funds because the allocation of disposable funds of commercial banks is not well implemented. As a result, the interbank interest rates do not really become an impressive information source for the management of the SBV's monetary policy. In such a situation, the refinancing interest rate instrument is very blunted in impacting commercial banks' setting of trading interest rates. Although the SBV has step by step turned the mechanism of refinancing in the form of designated loans and mortgage of credit documents into that of discounted loans and mortgage of Treasury bills, SBV bills and other valuable papers.

3. Suggestions

In the past years, Vietnam's interest rate management policy has experienced fundamental changes in accordance with the development trends of the economy. The process of financial liberalization has been implemented from a subsidized policy to interest rates liberalization in the condition that the economy is step by step integrated in the world and the regional economies. The key objective is to build a system of market interest rates which are set in accordance with the supply and demand rule. These rates have close relations with those on the regional and the world market. Thereby the capital regulation of the Vietnam's financial market can be expanded. One of striking points of the interest rates liberalization process is the SBV's role in interest rates management as a captain; this requires the SBV to replace administrative measures and direct intervention with management by indirect instruments.

Nevertheless, the success of the interest rates liberalization policy depends on the following conditions:

+ The system of finance and credit develops effectively in competition and well undertakes the role of a financial intermediary. The policy credit should be separated from the banking system and the credit institutions' professional skills improved.

+ The finance market (including the monetary market and the capital market) grows reasonably in term of structure with the aim to facilitate credit institutions' capital regulation and competition.

+ To create a liberal business environment, improve the activeness and flexibility of credit institutions and rectify the legal frame for healthy competition of credit institutions.

As a result, in the next 10 years, the process of interest rates liberalization may be divided into the following stages:

From 2001 to 2005: On the condition that the interest rates for foreign currency has been liberalized, the SBV is required to take appropriate steps to the liberalization of interest rates for local currency. It should focus its efforts on developing the monetary market; establish the structure of major interest rates on the monetary market including: SBV's refinancing interest rates, interest rates for bids on Treasury bills and SBV bills; and interbank loan interest rates. Once the role of these kinds of interest rates has been fully implemented for market stabilization, the SBV may cancel the practice of setting the basic interest rate to liberalize interest rates.

Nevertheless, since the monetary market is currently in the process of perfection, the suitable step for interest rates liberalization in this stage is to free the interest rates for short-term loans and the SBV still has to maintain the mechanism of managing the basic interest rate and trading band for long-term loan interest rates. The suggestion is based on the following points:

- To help credit institutions take the initiative to deal with complicated changes in interest rates on the world market and reduce risks in their business.

- To promote credit institutions' competitiveness and give autonomy to them in deciding loan interest rates suitable to each bank's real situation and borrowers, thereby spurring the development of the capital market.

- To liberalize the short-term capital flows and generate a momentum for the development and expansion of long-term capital demand, thereby establishing the foundation for long-term loan interest rates liberalization.

- To harmonize the relation between interest rates for local and foreign currency with the aim to enhance the forex control policy. At present, the interest rates for foreign currency have been already liberalized but local currency interest rates have not. This will result to the fact that interest rates have not yet become an instrument generating the internal forces to adjust the exchange rate on time when there are currency upheavals. Nevertheless, if the local currency interest rates are liberalized, these two kinds of interest rates will be interactive and the difference between them will depend on the market. As a result, the foreign exchange rate will change in accordance with the market mechanism and the supply and demand relation on the forex market.

On the condition that the capital market has not yet operated in order and it has no close connection with the monetary market in balancing the supply of and demand for capital, the SBV still uses the trading band of the long-term loan interest rates with a view to facilitating development investment and preparations for the next stage.

From 2006 to 2010: In the period, the economy has fully integrated in the region. Therefore, the activities of the monetary market will be expanded. On the monetary market, foreign commercial banks are permitted to trade in local currency, create a perfect competition mechanism and the Vietnam system of commercial banks begin to stretch to international markets. Furthermore, after a period of consolidation and development, the capital markets operate in order, not only accept the mechanism of floating short-term loan interest rates but also build a ground for the application of long-term loan interest rates compatible with the market mechanism.

Based on the development grounds, the SBV may implement the policy on full liberalization of interest rates, abolish the basic interest rate policy and management by trading band for Vietnamese đồng loan interest rates. At the same time, the SBV will enhance the utilization of the refinancing tool and combine it with the open market interest rates for intervention and adjustment of market interest rates.

From 2011 on: The stock market will become one of main channels of the capital market in transferring capital and regulating capital flows in combination with the monetary market. With its interest rates liberalization, the SBV will use the tool of open market to manage the interest rate policy in accordance with the market mechanism at higher level.■