

Contents

Introduction.....	1
1. The Current Status of the Financial Sector in Viet Nam	2
Financial Institutions.....	2
The Inter-bank and Securities Markets.....	8
2. Performance of the Financial Intermediary Function.....	11
Share of deposits and loans at financial institutions.....	11
Performance of Resource Mobilization.....	12
Performance of Resource Allocation.....	16
Interest Rate Policies for Improvement of Financial Intermediary Function..	20
3. Actions Underway and Future Directions for the Improvement of the Financial Intermediary Functions.....	22
Actions underway.....	22
Issues on Corporate Governance, Ownership and Banking System Design.....	26
Development of capital market for complementing banking system..	29
Conclusion Remarks.....	30
References, Boxes, Tables.....	31

Introduction

Let take a grasp of the entire economic picture of Vietnam. Nearly 70% of the labor population is reported to engage in agricultural sector, which accounts for only 23.6% of the total GDP. This simple fact alone can reflect an utter need of Vietnam to quickly promote the process of industrialization if her citizen was to break away from poverty. Among a huge number of challenges, the issue of capital mobilization and its utilization, which fatally depends on the functioning of the financial system, is obviously the one of utmost importance. Then, one of the challenges comes to be the issue of developing an efficient financial system.

As seen in table 1, statistical data shows that capital resources for industrialization of this country over the past 5 years from 1995 - 2000 was formed almost equally by domestic and foreign capital, with a slight overweight of the former. According to estimation of the Ministry of Planning and Investment of Vietnam, during the 2001-2005 period, at least VND 840,000 billion (or about US\$ 60 billion) will be mobilized for development investment, of which one third is planned to come from the foreign sources and the remaining two thirds from the domestic ones. Needless to say, whether the highly expected proportion of domestic capital mobilization is attained, depends almost solely on whether the financial intermediaries function well enough. It is this rather obvious but critical point that stirs my interest to take an insight into the performance of current financial intermediaries in Vietnam.

Thus, the main purpose of this paper is to grasp an insight of the current functioning of financial institutions in Vietnam, identify the problems and find directions for further improvement of the system in light of the problems observed. Based on the perception that Vietnam's financial system inherits legacies from previously planning mechanism where the capital and securities markets were absent, and consequently banks are taking the dominance not only in the present but also in near future, this paper puts emphasis on bank sector's intermediary functions. Though the long-term development of a financial sector may depend on other important issues including of industrial development and FDI attraction policies, as controversially asserted in a considerable number of researches, this paper in its scope will not expand arguments further these issues but focus on the performance of current financial sector and how to improve intermediary functions to attain high mobilization and efficient allocation of domestic capital. The study period is mainly from 1995 to 2000. Regarding the methodology, primary information of the research is obtained from annual reports and official releases of the State Bank of Vietnam, the Ministry of Planning and Investment of Vietnam, the General Statistic Office of Vietnam, specialized magazines and newspapers, and international institutions that include Japan International Cooperation Agency, Asian Development Bank, World Bank, and the IMF.

The paper is organized from three sections. To make the premise for following arguments, first section tries to draw a bird's-eye view of the entire financial sector of Vietnam, reviewing the overall performance of the system's individual part inclusive of banks, the inter-bank market and the bond and securities markets. The section at

the same time tries to figure out the existing overall problems. Second part seeks to dig down into concrete problems existing in the both side of resource mobilization and allocation through analyses of available data. It aims to reveal the poor performance of the financial intermediaries through providing insights into the current situation of deposits at financial institutions, saving practices of people in urban and rural areas regarding mobilization function. As for the latter function of allocation, analyses were provided to point out the bad lending practices that result in difficulties for private sector to access funds, and above all, the huge stock of non-performing loans that burden the entire economy. After taking a review of reforms already underway by the government under assistances of international organizations, the third section, which is the core, tries to put forward some directions for the development of an efficient financial sector in light with so far analyzed implications. Conclusion remarks provide summaries of previous arguments and directions for futures.

The Current Status of the Financial Sector in Viet Nam

Financial Institutions

After the liberation of Vietnam in 1975, the whole banking system of the old regime, which included seven state-owned banks and about thirty private and foreign banks, was nationalized. The government established the State Bank of Vietnam to perform both central banking policies and commercial banking activities. In 1988, the four current state-owned banks - Bank for Foreign Trade (Vietcombank), Industrial and Commercial bank (Incombank), Bank for Investment and Development (BIDV) and Bank for Agriculture (VBA) - were split from the State Bank of Vietnam to perform commercial banking activities. In 1986, the Sixth Congress of Vietnam's Communist Party marked a thorough change in government's attitude towards the private sector and foreign investment introducing a reform program referred to as "Doi Moi" to develop the private sector, restructure the financial sector and the budgetary system, to focus on export-led growth and attract foreign investment. In May 1989, the Council of Ministers passed two Ordinances; one on State Bank of Vietnam, and one on Banks, Credit Co-operative and Financial Companies of Vietnam, to regulate banking activities. The State Bank of Vietnam continues to perform the traditional role of the central bank and governs the whole banking system in Vietnam. The State Bank of Vietnam (SBV) works closely and in tandem with the Ministry of Finance. The SBV has a network of branches at provincial level and one regional office located in Ho Chi Minh City looking after the south. There are five categories of banks in Vietnam, as shown in Box 1.

Regarding the relations between the state-owned enterprises and banks, the situation is as follow. Distribution of capital and credit to the state-owned enterprises is the responsibility of the commercial banks. Commercial banks are given the following areas of activity and functions. Loans to state-owned enterprises to expand production are mainly granted by the Vietnam Investment Development Bank. Loans for external economic activities are mainly granted by foreign trade bank.

Commercial and industrial bank is in charge of lending loans for trade and service related enterprises, and agricultural bank in loans for agriculture and local enterprises.

The fund sources for state-owned enterprise capital and loans are considerably diversified, including domestic fund sources, overseas fund sources, borrowing from the government, and bank loans. Thus, the state agencies can try to intervene with loans to state-owned enterprises through the following ways. As for external borrowing, the Ministry of Finance, the Ministry of Planning and Investment, and the Vietnam State Bank intervene with distribution of capital and credit for state-owned enterprises. Of these, the Ministry of Finance is responsible for borrowing and repayment through the government and is required to select a proper commercial bank for borrowing and subleasing to state-owned enterprises in cooperation with the state bank. As for external borrowing by the state-owned enterprises, there are many interested parties such as the state bank, government institutions and commercial banks. In particular, the state bank has the authority to control the total amount of borrowing and the upper repayment limit of the state-owned enterprises and has a role in examining borrowing plans. The governmental agencies belonging to the management of the state-owned enterprises approve the proposed borrowing plans of the state-owned enterprises to determine the viability of providing guarantees. Borrowing and repayment are executed by the commercial bank system. As for the capital and assets of the state-owned enterprises mobilized by commercial banks, the banks have the authority to determine the loan values and conditions according to the relevant rules.

The four state-owned banks still dominate the banking industry and account for 71.9% of total banking assets in Vietnam, but their balance sheets as well as those of some joint-stock banks are reportedly heavily burdened with bad debts, as examined below in section two. Joint-stock banks hold 10.5% of the total banking assets, foreign and joint-venture banks hold around 16.0%, and the rest belongs to the credit co-operative network. Some of the joint-stock banks, mostly in Hanoi and Ho Chi Minh City, are licensed to perform international banking services and foreign exchange activities. Two local commercial joint-stock banks (Asia Commercial Bank and Vietnam's Bank for Private Enterprises — VP Bank), where foreign ownership of up to 30% is allowed, are considered as trials by the SBV. In 1998, six joint-stock commercial banks and several others were placed under "special control" by the SBV. A total of fourteen were considered to be in trouble and were to be restructured. Regarding the operations, banking services other than credit services are rarely offered. (Table 2)

The situation of people's credit funds is as follow. In 1993, on an experimental basis, the State Bank of Viet Nam established commune-based people's credit funds (PCFs) based on the Quebec (Canada) credit cooperative model. The PCFs expanded rapidly, and at the end of 1996 there were approximately 826 of them, with total outstanding loans of about 1 trillion Vietnamese dong (VND). The interest rate of deposits and loans at PCFs is high compared to agricultural banks, but the procedures are said to be simple. In contrast, the assets of credit cooperatives are not increasing. The funds mobilize capital and lend to their members. The average own capital is

about VND 1.3 billion. By the end of 2000, their credit outstanding is over VND 4 million while the profits are low. Although the data are not provided, it is asserted that many people's credit funds have high ratio of overdue debts but in many provinces and cities they exposed high credit quality¹.

As for the foreign bank branches in Vietnam, the charter capital is USD 10-15 millions. Their credit provisions to a customer are not subject to the limitation of 15% of owned capitals. The ratio of overdue debts in these institutions is less than 1%. All of them are making profit. The ratio of profit to capital is nearly 10% and the ratio of profit to assets is about 4%.

Regarding joint venture banks, there are four joint venture banks by the end of 2000. The charter capital is USD 15 million each. The credit provision to a customer is subject to limitation of 15% of owned capital. It is said that there are only two banks (Indovina bank and Vidpublish bank) are operating efficiently and providing high-qualified services².

Followings are the overall features of the above-mentioned institutions.

Poor Capital and Reserves

Most of the local banks are very under-capitalized, especially the joint-stock banks. In case of the state-owned commercial banks (SOCBs), the situation is as follow. The charter capital of the Bank of Agriculture and Rural Development is VND 2,200 billions, equivalent to USD 150 millions. This of other three SOCBs is VND 1100 billions each, approximate to USD 75 millions. The capital adequacy ratios of SOCBs are lower 8% of the international minimum level. (Table 2)

As for the joint stock banks, the claimed legal capital is about USD 3.5-5 millions for the bank in urban and USD 350 thousands for one in rural areas. At present, up to more than one-third of urban joint-stock banks and almost all rural joint-stock banks are under-capitalized. The banks' low capitalization may be due to their under-registered capital or actual or potential loan losses due to a variety of reasons. Of the 18 commercial joint-stock banks based in Ho Chi Minh City, only seven meet the minimum capital requirement. Some of the rest are very far below the minimum capital requirement, for example: Nam A Bank (VND 30 billion), Mekong Bank (VND30 billion), Dai Nam Bank (VND25 billion). Almost all joint-stock banks have been unable to increase their capital and unable to take on board new shareholders due to investors' hesitance over their "diseases". No loan loss provision was required until the coming of the Law on Credit Institutions of Vietnam in 1 October 1998. Every year, banks are requested to set aside 5% of their net profit to supplement their charter capital.

Similarly, it is compulsory for banks to set aside 5% of their net profit to top up their special reserves. (Although banks are prohibited from using the funds, the purpose and mechanism of using this reserve are not clearly defined). Because reserve funds are set aside from the net profit of the bank, they depend positively on

¹ See Nguyen Ngoc Bao, "Ad hoc Measures to Deal with Banking Debts" in Study on the Economic Development Policy in the Transition toward a Market-Oriented Economy in the Socialist Republic of Viet Nam, Phase 3, MPI & JICA, 2001

² Same as Note 1.

the profitability of the banks and not on the amount of risk-weighted assets.

Group Lending and Related-Party Lending

The problem of related-party lending could have originated from establishment of joint-stock banks in Vietnam. It seems that a joint-stock bank is usually backed by a family or a group of related companies, which are also its shareholders (usually the founders). Therefore, a bank is established to satisfy their banking needs rather than as an investment scheme. In addition, there was no regulation on related-party lending until the enactment of the Laws on Credit Institutions on October 1998. It is discovered that a large portion of the private banks' loans were poured into their shareholders or related companies, board members' businesses and the banks' staff. The Banking Ordinance allowed banks to lend to a single customer up to 10% of the bank's own capital and reserves. This has been adjusted to 15% under the new Laws. However, due to inadequate disclosure and information, it is nearly impossible for bankers to assess the performance of group companies. There is no statutory requirement for the banks' directors to declare their interests which conflicts with their duty or interest as a director. To increase loan portfolios and win businesses, some banks have even intentionally ignored the risks of group lending.

Poor Risk Management:

Risk management has always been a part of banking management although it may have been conducted under different names and for different reasons. The past few years have witnessed extraordinary growth in banking products and services in Vietnam. It appears that some banks have experienced problems as a result of expansive operations and have neglected prudential principles. A growing banking industry will become more vulnerable if it is unable to evaluate the risk of the increased lending and diversification of products. Vietnamese bankers have not had the experience of market-based banking activities. The current problem of bad loans in the banking system has been described as a matter of bad risk management. Banks make loans mainly on their evaluation of the collateral pledged rather than forecast of the borrower's ability to repay the loans. The maximum lending limit to a single customer under the present law — 15% of capital and reserves (Box 2)— partly reduces the credit risk on concentration. However, the regulation also limits lending to large and profitable projects since the banks' capital is very small so that the banks are under pressure to augment their capital. Poor risk management is reflected in the poor credit appraisal skills of the credit staff and the inadequate loan monitoring system. Little attention has been paid to off-balance sheet liabilities. Some banks do not even properly manage off-balance sheet activities resulting in the over-extension of guarantees to customers by issuing letters of credit, letters of guarantee and foreign exchange risk exposures. Some banks run a fundamental maturity mismatch, borrowing short from the public to lend long to the property sector. Erratic foreign exchange controls and the shortage of hard currency expose banks to foreign exchange risks. After a series of currency devaluation in 1997 and 1998, the Vietnamese Dong fell to 13,920 against USD. In September 1998, the government imposed strict controls on foreign exchange by forcing enterprises to sell 80% of their foreign currency holdings to commercial banks. Some banks had huge amounts of

contingent liabilities in hard currency but their ability to attract foreign currencies to meet demand is still uncertain. The banks' open currency positions (long or short) are limited by the law to 15% of capital plus reserves per currency. Whereas foreign currency lending to export activities is not allowed, the restriction does not apply to import activities where borrowers have foreign currency receivables. Liquidity risk concerns the availability of funds for the banks. The management of liquidity risk seems simple because one may think of it as just a certain minimum of liquid assets kept at the banks. But that requirement itself immediately throws up the need for a day-to-day management system to ensure that outflows are secured by the minimum level. In Vietnam, the problem seems more serious in joint-stock banks than state-owned commercial banks. Some joint-stock banks have used short-term funds (in Vietnam's banking system, the portion of short-term funds always exceeds the long-term one) for long-term financing (i.e. property). The Law of Credit Institutions has introduced safety ratios such as the current ratio and the funding ratio. The SBV requires commercial bank to hold a minimum of 7% of total deposits with the bank. Since confidence in the banking system has been undermined, the Vietnamese market has become very illiquid. Operational risk is the risk of poor performance of banking products or services arising from inadequate workflow, procedures and practices. Operational risk may also be rooted in an inefficient technology platform or inadequate job description, work guidelines and manuals. Most commercial banks in Vietnam do not have clear and systematic manuals for services and products to ensure smooth operation and securitization. The State Bank of Vietnam has issued general guidelines for some banking services. Underdeveloped and substandard IT systems have led to the loss of control over the integrity of data and the inability to provide timely and accurate data for risk management and development of sophisticated products and services.

Improper Accounting Practices and Transparency

Improper accounting practices and the dearth of timely and accurate information in Vietnam have led the lack of transparency. Companies in Vietnam are reluctant to declare their actual business and financial figures due to the overlapping and high-level of taxation, as well as, the desire to maintain business secrecy. This leads to inaccurate credit information for bankers. The Vietnamese accounting system is more concerned with defining the accounting system and processes required. Vietnam's accounting system uses statements of income and expenditure but items such as security revaluation losses; inventory revaluation losses are not included. The calculation of fixed assets depreciation is very simple and does not comply with international practices. A foreign company operating in Vietnam may need two accounting systems so that the company is able to report to its parent company in accordance with international practices. Financial institutions did not need to have their accounts audited independently until early 1998 when the SBV issued a decision requiring the accounts of financial institutions in Vietnam to be independently audited. While the Foreign Investment Law requires all foreign-invested companies to have their accounts audited, auditing is not compulsory for domestic companies.

Inadequate Managerial Skills

After decades of mono-banking, central planning and a subsidy system, bankers in Vietnam lack sufficient skills in bank management and knowledge of banking services. A large part of SBV's governance over the banking system still consists of administrative orders rather than through market instruments and forces. Management inadequacy manifests itself in the operating performance or low profitability. As for the SOCBs, the ratio of their profit to the average owned capital is over 5%. (Table 3) The ratio of their operating costs to assets is over 7% while this ratio of regional commercial banks is only over 2%. The retained earning of SOCBs is only enough to pay the fees for using government capital (6% of charter capital). The reason of low profitability is mainly due to low qualification of credit, partly incurred from low productivity, backward technology, weak management as well as mixed commercial and directed credit, in other words, the lack of autonomy. Technologies qualifications used in Vietnamese banks is far below in comparison with this in the international commercial banks. The management inadequacy reveals also at ineffective internal control and limited information. Vietnamese central bankers seem to emphasize more on the institutional structure of the banking system than the way banks operate. Indeed, more attention has been given to organization and processes than the measurement of risk, calculation of returns and credit analysis. In private banks, this weakness contributed significantly to the abuse of authority, resulting in the banks' exposure to the risk of credit extension to a limited number of debtors, particularly to individuals/business groups that have close ties with the banks. As mentioned above, due to the genesis of joint-stock banks from family businesses or community group businesses, many joint-stock banks have maintained many non-professional bankers on their board of management.

Organizational Behavior

In the strategies and operation of state-owned commercial banks, the implementation of government policies overrides issues of soundness, efficiency and profitability. The breakdown of controls, coupled with inadequate regulation and supervision, engenders corruption that discourages foreign and domestic investments, distorts government policies and eventually destroys the system's credibility. In joint-stock banks, shareholder's interests still dominate the objectives of many bank directors. With the exception of some foreign-invested banks, bank organizational structures in Vietnam are mainly based on convenience, given their existing human resources, and not on long-term business objectives and development strategies. Most private banks started from family or communal businesses. Although they have evolved into joint-stock companies, most of the shares are still controlled by certain families or groups of people, with the board of management coming from those selected groups. Because of the absence of a securities market, the banks' shareholders are only interested in short-term profits, as the dividends are the only source of capital gains. Personnel organization frameworks are designed (and sometimes decided) prior to the bank's business organizational structure. Decision-making is still influenced by personality factors. As mentioned above, many joint-stock banks have maintained many non-professional bankers on their boards of

management and they usually represent and act on behalf of the shareholder's interests. Generally, the organizational behavior in Vietnam's banks is bureaucratic and mechanistic, representing a corporate culture of low commitment to customer service, low regard for employee opinion and low staff responsibility. Banks do not have long-term business policies and targets and professional corporate cultures. Bank departments are organized according to functions (e.g. credit, accounting, transactions, and international settlements) rather than products (e.g. retail banking, corporate banking). The lack of detailed job descriptions results in seniority hierarchy, rigid job classification and difficulties in position rotation.

The Inter-bank and Securities Markets

Operations of Inter-bank Market

By rationalizing the settlement of accounts system, which forms the core of the banking system, it is possible to increase the confidence of people in bank deposits and hence promoted financial deepening. To this end it is necessary to create a settlement network that enables the transfer of reserve money between the commercial banks, including those not owned by the state, and to link this network to the central bank (SBV). By constructing such a system for settlement of accounts the convenience of the bank deposit system for the typical user is increased, causing an increase in the size of the demand for this service.

The settlement of accounts and fund transfer systems are being improved at a rapid pace. For example, regarding fund transfers within the network of each commercial bank, transfers are completed within the day on the existing network. However, it is still the case that the inter-bank network is underdeveloped, and that the facilities of the central bank are employed to make such transfers. In addition there are no local inter-bank markets in regional areas, so the various branches must depend on the main office for fund transfers for the purpose of adjusting fund excesses and shortfalls.

The development of a settlement and transfer network with the central bank as the hub is a vital policy issue. At present even the transfer system operating within the central bank itself is inadequate, so settlements carried out between the head office and local branches are organized by area of operation. Seen from the perspective of macroeconomic policy efficiency, each SBV branch is effectively conducting rediscounting for the various local banks. Such a system poses dangers to the unity of macroeconomic policy. In addition, at the level of the commercial banks and the local branches of foreign banks, the inefficiency of the inter-bank settlement of accounts mechanism and the lack of an operational inter-bank money market have led to the need for large amounts of reserves to be held at considerable cost.

Though a dong/dollar inter-bank market was established in Viet Nam several years ago, it was asserted that the dong inter-bank market is not particularly mature and is not functioning effectively³.

³ See *Vietnam Economic Times* (Thoi Bao Kinh Te), November 11 2001

The Dong Inter-Bank Market

The dong Inter-bank Market was established in July 1993, and the number of participants has increased from an initial 11 to 40 in 1995. In 1994, the average daily transaction volume was relatively low, at 40 billion dong. Interest rates on the inter-bank market are in principle determined by the relationship between supply and demand. The interest rates, however, is considered to have not sufficiently reflected the supply-demand situation. Bad functioning of the inter-bank market results in the facts that the banks had to stay with excess funds sometimes (for instance, early 1996) and encounter with shortage of money in other times. The situation also made foreign banks find it extremely difficult to procure Vietnamese dong (VND)⁴.

The Foreign Currency Inter-Bank Market

Following implementation of a new foreign-currency law intended to attract foreign currency under a system of proper foreign currency management, in October 1994 inter-bank foreign currency markets were established in Hanoi and Ho Chi Minh City. The number of market participants has increased from an initial 23 to 40 in 1995⁵. At around 8 o'clock each morning the central bank announces the official exchange rate, and the inter-bank market participants can trade among member banks at rates within minus plus 5% of the official rate, using a variety of communication lines. Total transactions per day are estimated to be in the range of \$10 million to \$25 million (95% of the transactions are dollar transactions). There is little liquidity and the market is still in its formative stage. Furthermore, the Vietcombank accounts for 85% of the transactions. Prices are not indicated for buying and selling, but only for one side of transaction.

Funds Transfer within Banks

Table 4 indicates funds transfers, on a year-end basis. According to this table, funds are supplied from the central bank to the state-owned commercial banks. In particular, the central bank is providing the BIDV with long-term funds (4,115 billion VND in 1996), and the Agribank with short-term funds (1,464 billion VND in 1996). Funds are also transferred from the state-owned commercial banks to foreign banks. In particular, the Vietcombank provided very large amounts of foreign currency deposits to foreign banks (4,998 billion VND in 1996). The reverse fund transfers between state-owned commercial banks and foreign banks are also taking place. While the BIDV and the Incombank obtained mostly medium to long-term funds, the Agribank obtained mainly short-term funds. There are few fund transfers between the SOCBs and the joint-stock banks, and the amounts are low.

The main state-owned commercial banks use the following procedures to adjust for excessive or insufficient funds. At the Agribank, overall funds management is handled at the head office. In the southern region, agricultural production is advanced and the demand for capital is high. Therefore, funds are more usually transferred to

⁴ See *Domestic and International Economies 1996-1997* (Kinh tế 1996-1997, Viet nam & The gioi), Vietnam Economic Times

⁵ See "The Current Status of the Financial Sector in Vietnam", in *Study on Economic Development Policy in the Transition Toward a Market-oriented Economy in Viet Nam*, Phase 2. MPI-JICA.

the south from north. The Agribank Danang Branch performs funds transfer functions for the central region, transferring deposits collected in urban areas to rural regions in the form of loans. At the Agribank southern regional center, funds transferred from the north are distributed within the 23 provinces under its distribution.

The funds flow at Incombank is on two levels: at the head office, and at other branches. If a certain branch has an excess of funds, it will send the excess via the head office to a branch that needs funds. The head office disposes of overall excess funds by purchasing Treasury bill and making deposits with foreign banks.

The Ho Chi Minh City Branch of the BIDV borrows long-term funds from the head office, but procures short-term funds directly. The branch has an excess of short-term funds, and lends them directly to other branches.

At Vietcombank, if a branch has excess funds, it transfers them to another branch via the head office. The Ho Chi Minh City Branch, unlike other branches, is not requested to transmit funds to the head branch, but can decide how to deal with excess funds on its own. If the head office has an overall excess of funds, it purchases treasury bills⁶.

Current Situation of Securities Market

Regarding government bonds, the Treasury bills and bonds market was set up in 1995, taking in the form of bidding form the yield based on estimated volume. The participants of the Treasury bills auctions are mainly state owned commercial banks, joint stock banks and insurance companies, of which the state-owned commercial banks are dominant in both amounts of registration and successful bidding. Thus, the bonds play virtually no role in accelerating domestic savings.

Bonds issued and auctioned include of 1-year maturity treasury bonds, 2 and 3-year medium bonds. These bonds marked an important step in the process of reforming and completing the capital mobilization mechanism through the State treasury. The debt mechanism has gradually changed from short-term to medium term that improves the efficiency of utilizing the state capital. Moreover, the issue of various bonds such as registered bonds and unregistered bonds, bonds with and without par value, which are freely convertible throughout the country, has drawn great attention of consumers and created a material premise to set up the capital markets in Vietnam. Regarding the disseminating mechanism of bonds, auctioning market is held where the Ministry of Finance works in collaboration with the SBV to auction bonds for raising funds according to the demand of the state budget (with the maturity of 6, 9 and 12 months). However, the current bonds market is still in its immature stage. There are no bonds with long maturity of 5 years or above that makes the bond trade on secondary market more restrictive. Furthermore, government bonds have not yet been standardized for being listed on the securities market. Additionally, the bond portfolio has not been diversified; the dearth of modern bonds including of discounted and called bonds limits the utilization of capital potential in the economy. Status of fund mobilization of government bonds in 5-year period from 1995-1999 is

⁶ See “The Current Status of the Financial Sector in Vietnam”, in Study on Economic Development Policy in the Transition Toward a Market-oriented Economy in Viet Nam, Phase 2. MPI-JICA.

described in table 5.

Enterprises bonds as stipulated in 1994 include bonds issued by state enterprises, joint stock companies, banks and limited liability companies. Bonds issued by state owned enterprises can be freely traded, transferred, inherited and used as collateral and are distributed in three ways: direct distribution, through distribution dealers or auctions. The problem with enterprises bonds is that, while the relevant legal framework has been set, it is said that only a few of enterprises used these designated methods to raise fund because of difficulties encountered during the process of approval and other causes⁷.

Fund mobilization through shares and the stock market, which had come into action from July 2000, appears to be better but seems not to be subject for excessive optimism.

After over two years of operations, the number of brands remains at 17 and the prices show continuous swing. Investigations carried out by the Investment Review Newspaper reveal that most of enterprises hesitate to go to public due to several factors including of the unawareness of the market plus the devious movement of the prices.

According to the State Securities Commission, which has been directly responsible for the establishment and governance the securities industry in Vietnam, the plan for development of Vietnam stock exchange market has two periods from 2003-2005 and from 2006-2010. In 2003, the listing companies in Hanoi stock exchange will be 10-15 companies and raising to 100 companies by 2005 and 700 companies by 2010. While the listing companies in Ho Chi Minh City stock exchange will be 20 at the end of 2002 and 100 companies by 2005, ad raising to 500 companies by 2010. The volume of the market will be increased to 4.5 percent of GDP in 2005 and 15-20 percent of GDP in 2010. According to plan, the first period (2003-2005), the stock exchange will comprise: Stock exchange market in Ho Chi Minh City specializing for transaction of shares issued by companies having capital of over 10 billion Vietnamese dong, with semi-automatic supervision, and Stock exchange market in Hanoi specializing for transaction of shares issued by smaller companies, with semi-automatic supervision. And the second period (2006-2010), the market will comprise: Stock exchange markets in Ho Chi Minh City and Hanoi. Transaction in Ho Chi Minh City will cover high quality shares issued by big companies with capital of VND30 billion upward. Transaction in Hanoi will cover only shares issued by the small and medium sized companies.

2. Performance of the Financial Intermediary Function

Share of deposits and loans at financial institutions

From 1993 to 1996, changes in shares of deposits and loans held by Viet Nam's major financial institutions were as follows. (Table 7)

Regarding deposits, the share of total deposits held by the four state-owned

⁷ See "Bao Dau Tu" (Investment Review), 10 March 2001

commercial banks dropped from 91% in 1993 to 76% in 1996, while the share held by joint-stock banks increased from 6% in 1993 to 10% in 1996. It is said that the Vietnamese have more confidence in the state-owned commercial banks and that therefore the joint-stock banks need to provide higher interest rates on deposits in order to mobilize funds. Also, as a result of an increase in the number of foreign bank branches, their share of deposits increased from 2% in 1994 to 8% in 1995 and then increased to 11% in 1996. Foreign banks are under a restriction, which allows them to accept up to just 25% of their allocated capital and reserves in dong deposits from customers who have not taken out loans with them, but this restriction does not appear to impose a serious hindrance for many of the foreign banks.

Of total loans, the share held by the four state-owned commercial banks dropped from 89% in 1993 to 74% in 1996. In contrast, the share held by joint-stock banks increased from 7% in 1993 to 15% in 1995. The share of loans held by foreign branches has also increased, from 3% in 1993 to 7% in 1995, reflecting the increase in the number of foreign bank branches. The activities of the foreign banks are mainly the procuring of capital from overseas and lending (foreign currency) to multinational corporations and joint ventures. This is because financing for domestic corporations is difficult as a result of difficulty in procuring dong and a lack of corporate information. As a result, the companies with which many foreign banks can do business are limited to multinational corporations, certain state-owned enterprises, the four state-owned commercial banks, and certain joint-stock banks. Some foreign banks, however, are aggressively moving to develop loan customers. Since 1996, foreign banks and joint-venture banks are no longer permitted to accept land-use rights as collateral on new loans.

Regarding credits among state-owned commercial banks, (**Table 7**) the four state-owned commercial banks had their share in total loan outstanding decrease from 89% in 1993 to 85% in 1994, and to 74% in 1996. Accordingly, other private banks increased their share from 11% to 15%, to 26% in 1996. The Agribank had its share decrease from 27% in 1991 to 20% in 1996, reflecting a change in the industrial structure toward industrialization, and the Incombank had its share decrease from 27% to 20% over the same time frame, due partly to the intensifying competition with the emerging private banks. The BIDV increased its share from 12% in 1991 to 20% in 1996, reflecting a strong demand for long-term loans for capital investment. The share of long-term loans in total loan outstanding for non-government sectors increased from 16% in 1991 to 32% in 1996.

Among the state-owned commercial banks, the Bank for Agriculture and Rural Development accounted for comparably high share of total credit (**Table 8**) that reflects its large network to response to demand in the rural areas. In addition, the Government has paid attention to agriculture and rural development. The credit to agricultural and rural sector are mainly lending to effective programs and investment projects packing the production cycle from production to purchasing, processing, marketing and export of rice, tea, coffee, cashew nut, rubber, sugar production, fertilizer imports, lending program for “anti-flood house base upgrading and shelter-on-stake house construction in Mekong River Delta”, lending to fishery households.

The credit growth rates of the Bank for Industry and Commerce and Bank for Investment and Development also increase in line with the government's direction of promoting export processing industries and infrastructure projects.

Performance of Resource Mobilization

Analysis through deposits at financial institutions

Two features were observed from the available data, which are comprised of firstly, the concentration of deposits at the SOCBs, and secondly, the comparably low fund mobilization from rural areas.

Regarding the first point, Table 7 reveals the fact that, although the banking system has been expanded since 1990s, flows of deposit have still been highly concentrating on the state-owned commercial banks.

The main reason is that these banks have advantage of capital scale. The state-owned commercial banks account for 71.9% of total financial assets of the whole banking system, so these banks have set up a comparably wider branches network compared with that of non-state owned institutions and have traditional relations with many clients. Moreover, from individuals and households' point of view, the state-owned commercial banks have bailout from government. Therefore, the saving deposits center at the state-owned commercial banks despite the fact that deposit interest rates of non-state-owned commercial banks are higher than those offered by the state-owned commercial banks⁸. Regarding the fund mobilizing capability of the joint stock banks, the fact that they have been established recently with small capital, narrow branch network and lack of traditional clients suggests that their competitiveness is weak as compared to that of the state-owned commercial banks. Some loss-making banks that faced credit collapses and insolvency have been put in special supervision by the State Bank of Viet Nam, constraining the banking system's fund mobilizing. As to the foreign bank branches, despite of high credibility gained among people and sound financial situation, they are still subjected to the limitation of fund mobilizing level. The minimum of Vietnamese Dong demand deposits from individuals and legal entities that have no credit relation with these banks equal to 25% of the authorized capital provided by their parent banks (The Decision of the Governor of SBV No 300/QD-NH5 dated 13, November 1996 on amending of operations scope of the foreign bank branches and the joint venture banks in Vietnam).

The comparably low mobilization of fund at rural areas is observed as follow. Table 9 indicates the current status of deposits at state-owned commercial banks as of the end of 1996. While the population of Hanoi plus Ho Chi Minh City on aggregate accounts for only one tenth out of the total, the proportion of deposit from these areas makes up 22 to 83% out of the total. This observation can be partly attributed to the easier accessibility to banks compared to that in the rural areas. This issue will be furthered exemplified in the following part.

The specific characteristics of each state-owned commercial banks are as follows. In the Agribank, 71% of the deposits are from individuals. 73% are time deposits, and

⁸ See *Domestic and International Economies 2000-2001*, (Kinh te 2000-2001 Viet nam & The Gioi), Vietnam Economic Times, 2001

most are dong deposits. The Agribank has expansive deposit collection sites, (approximately 2,600 locations), located mainly in agricultural villages. There are thus numerous deposits in rural areas and about 22% of the deposits are from cities like Hanoi and Ho Chi Minh.

In the BIDV, the percentage of deposits from state-owned companies and individuals is low: most depositors are private companies or from other sectors. 71% of deposits are demand deposits, and about 80% are dong deposits. About 28% of the deposits are from urban areas.

In the Incombank, deposits from individuals comprise 39% of the deposits, while state-owned companies account for 31%. 91% percent of all deposits are dong deposits. In recent years, the bank has been increasing the number of deposit collection sites, known as transaction offices, and it now has about 800 locations (including branches), mainly in cities. Deposits in Hanoi and Ho Chi Minh city account for 49% of the total deposits.

In the Vietcombank, deposits from state-owned companies account for 41% of the deposit, the highest figure among the state-owned commercial banks. About two-thirds of the deposits are demand deposits and 53% are dong deposits. The Vietcombank has few branches, and because state-owned companies are concentrated in the cities, the percentage of urban deposits is relatively high at 84%.

Since 1992, state-owned commercial banks have been issuing bonds to raise funds, and these bonds have become an important way for the Incombank and the Agribank to mobilize fund from individuals. Almost all the bond issues have a short-term maturity, however, and because there is no secondary market for trading the bonds they serve merely as an alternative for deposits rather than as a means for raising long-term funds.

Saving practices among household

This section seeks to find the answer for the question “what are people likely to do to keep their surplus money”. While the data suggests that households invest most of their monetary surplus into accumulating real assets, mostly to purchase or repair houses and land, there is at the same time an interesting difference in saving behaviors between households in urban and rural areas that give much of implication for building a more effective fund mobilizing mechanism.

Table 10 shows the relationship between expenditure classes and savings and investment. Current Savings (1) is the value of savings when the purchases of durable consumption goods such as motorbikes and TV’s are counted as a part of the accumulation of real assets rather than current consumption. Current Savings (2) is the value of savings when they are included in the current consumption.

One interesting fact about the savings rate in this table is that its value is lower for households in higher quintiles in current expenditure. As for savings rate (2), it takes on 25% to 27% for quintile 1 and 2, but only 13.5% for households in quintile 5. This implies that households in higher current expenditure quintile spend a larger proportion of their income to purchase durable consumption goods in comparison with households in lower quintiles.

The average savings rates of the households sector are 28.6% and 17.1% for

Savings rate (1) and (2) respectively. These values themselves may not be very low. But households invest most of these savings into accumulating real assets, mostly to purchase or repair houses and land. As a consequence, accumulation of monetary assets which are used as vehicles to transfer resources from the household sector to the business and government sectors become extremely small, only 0.6% of current income. At present the financial surplus of the household sector as a whole is only of a negligible size.

Table 11 provides additional evidence on the interface between households and formal and informal financial institutions. It shows (1) how a household allocates its financial surplus among various financial assets including gold and (2) how it finances its financial deficits, when it has financial surplus or deficits in certain months. That is, it describes the linkage between financial surplus or deficits of a household with the changes in its financial assets and liabilities.

We can find that, when a household has a financial surplus, it splits the surplus mostly to increases its cash (76.0%) and gold (10.8%) and partly to reduce its debts (9.9%). When it has deficits, it finances the deficits mostly by reducing its cash (78.9%) or gold (5.7%) and increasing its debts to relatives or friends (4.8%) or banks and other financial institutions (2.8%) or sellers (2.8%). Again the contact of households with formal financial institutions is mostly limited to small amount of borrowings.

Implications

Many policy alternatives exist in such a situation. If housing investment is given a priority, then the household sector should not be expected to produce substantial resources for investment in the business sector. Major source of growth of enterprises must come from its own retained earnings or foreign investment. If investment in enterprises is given a priority, then a set of policies come to be necessary to induce households to invest more in monetary assets rather than purchasing houses and land. Problems will be less severe if priority is given to investment in houses and land, since there exists a well-developed informal credit market. But that policy is also with some problems. There is some reason to suspect that land price bubbles have already been built into the portfolio of assets of households. Table 11 shows that the fraction of the real assets (most of which are real estate) is 93.3% of the total assets in the investigated households. If banks remain weak, households are more likely to invest in gold or land, which is not consistent with the sustained growth of the economy. This indicates that a clear land price policy will be necessary.

The fraction of households with positive deposits is slight compared with the entire sample households, being equal to 4%. The average size of deposits per household is VND19,432,000, four times larger than the sum of cash and cash equivalents, that is, currency, dollar and gold. It is even higher than their annual current expenditure or the total value of durable goods they possess.

The allocation of zero's in the two columns in Table 11 reveals one important fact: the rate of return of deposits dominates the rates of return of traditional interest earning assets. This is based on the following observations. On the one hand,

households with deposits have only marginal loans to ho/hui⁹, no personal loan with interest, no debts to ho/hui, negligible personal debts with interest and no debts to moneylenders. It is clear that households with access to deposit facility of banks substitute bank deposits for traditional interest earning instruments. On the other hand, households without deposits have a significantly larger value for each of the traditional interest earning assets. Combining these two observations, we can conclude that deposit facilities of banks are available or useful only to those households, which are rich enough to deposit a large amount of money in banks. Consequently, there is a minimum deposit size that is binding in the portfolio decision of households.

The policy implications are as below. There is a need to eliminate the minimum size constraint of deposits. The banking policy should be designed in such a way that banks benefit from attracting small depositors and that households benefit from depositing even a small amount of money in banks. Obviously the present regulation on the interest spread contradicts with such requirement, which will be discussed further in section 3 of this chapter. Another important implication is that, because the deposits are infallibly increased in the areas where the accessibility are considered to be high, the expansion of deposit mobilizing sites is considered to yield a big effect in spurring deposits. This issue will be further discussed below.

Development of Branch offices in the Banking Sector

Table 11 puts up the difference in proportion of deposit as a monetary asset between areas. Because regions 2, 4, 6 represent large cities with high accessibility to banks, and regions 1, 3, 5, 7 refer in turn the rural areas with low accessibility, the data suggest that there is the room for improving the accessibility. The issue comes to be the banking policies that encourage expansion of institutional networks for deposit absorption.

An effective means of educating people as to the convenience of holding bank deposits is the construction of an appropriately sized banking network. While it appears that the individual commercial banks have considerable freedom with respect to the establishment of new branch offices, the question is whether or not the individual banks are able to present incentives sufficient to significantly increase deposit amounts.

That the mobilization of the savings dispersed in small individual quantities in the agricultural villages through banks deposits is vital to economic development has been amply demonstrated by the Chinese economy in the 1980s. On this point, of equal importance to the branch network of the commercial banks are the those of the credit cooperatives and the People's Credit Fund (PCF). From the perspective of the central and local governments, it is necessary that steps be taken to ensure the financial health of these smaller scale financial institutions operating in regional areas, and to increase their reliability through the introduction of some form of deposit insurance scheme. Some portion of the savings mobilized in agricultural areas can then, through the inter-bank markets, be transferred to the center where the demand

⁹ A form of informal credit

for funds is strong and serve as input in the capital formation process.

In the case of Japan the post office savings system was effective to some extent in mobilizing such dispersed funds through its nationwide network and the credibility of the state. Regarding Viet Nam, similar results could be expected if the government were to intervene to shore up the credibility of these institutions.

Also consistent with the better performance of Bank for Agriculture, the establishment of state-owned regional commercial banks by each local province would likely be an effective policy move.

Performance of Resource Allocation

After taking an overall look on the status of resource allocation among economic sectors, this section seeks to find main problems in the current lending situation. Three main features are observed from the available data, which comprise firstly, the high proportion of short-term loans compared with long-term ones, secondly, the concentration of loans in state-owned sector, or the hesitation toward lending to private sector in other words; and the last and the most severe one comes to be the huge amount of non-performing loans accumulated in the financial sector that epitomizes bad lending customs.

Investment by Sectors

Table 12 and 13 show the allocation of capital among economic sectors. 38% of total investment is public investment and 62% is commercial based. Commercial investment funds are half raised by FDI and half by domestic borrowings. Public investment covers 38% of economic infrastructure investment and 58% of social infrastructure. 85% percent of investment in the industrial sector, a part of economic infrastructure, is undertaken on a commercial basis, of which 58% is by FDI. The domestic private sector is expected to invest in economic infrastructure such as agriculture and transportation, and social infrastructure such as water supply and other urban infrastructure, as well as in education and health.

Fiscal funds still play an important role in medium- to long-term finance (investment finance). The government's low-interest loan is currently supplied through the General Department of Investment and Development (GDID) and Bank for Investment and Development. The government projects, which are funded by fiscal funds, can be classified into three categories, from the perspective of implementing institutions: (1) strategic projects that do not require collateral. (2) investment projects which can offer themselves as collateral, and (3) other projects. The GDID and BIDV have the authority to make credit decisions on projects in category (3) from a financial viability perspective, but projects in categories (1) and (2) are beyond their purview. (Appendix 1)

Share of Credits by Maturity

Vietnam shares the same dilemma with other developing countries in the sense that, while the process of industrialization requires huge amount of long-term loans, the capital is not supplied enough through the financial system due to several reasons including of factors pertaining to the fundamental economy as low saving rate, and

the problems of efficiency at the financial institutions themselves.

Though the upward trend of medium and long-term loan was confirmed in **Table 14**, the consistently low proportion reveals the dominance of short-term loans in the outstanding loans. To encourage long-term loans for economies, the State Bank has issued regulations on medium and long-term credit (see “Regulations”) under which credit institutions are allowed to use a proportion of short-term deposits for expanding medium and long-term loan. This regulation gives more autonomy to credit institutions in considering loans to medium and long-term project. In addition, the credit institutions are also allowed to provide syndicated loan and credit procedures are more simplified.

The possible explanation for the trends of persistently low long-term loans, along with the lacking of savings and capital in the domestic economy, is the fact that, while the industrialization process usually accompanies with highly risky projects, the concerned lending abilities of financial institutions, especially project evaluation and risk management skills, are seriously inadequate as mentioned in chapter 1. Additionally, low saving mobilization and weak abilities of maturity transformation in financial system is an unignorable factor.

Then how to improve long-term capital for industrialization? While the active introduction of foreign direct investment as a pulling role in the industrializing process seems to be an undisputed answer, there left much room for financial policies. Above all are the issues of redesigning an effective financial system that tolerate foreign and appropriate private ownership, and a system of commercial and long-term credit banks working in tandem with each other. This issue will be furthered discussed in chapter 3 below.

Share of credits by borrower

As for the distribution of credits by borrowers, the SOE sector accounted for 90% in 1991, followed by the private sector (5%) and others (5%). In 1996, the SOE sector share decreased to 54%, the private sector increased to 26% and other increased to 22% (Table 15). As to Agribank, its major borrower was the SOE sector in 1991 (80% share), but this was replaced by the private sector, which in 1996 occupied a 79% share. The BIDV and the Vietcombank extend loans mainly to the SOE sector. The Incombank and other private banks have gradually shifted their loans from the SOE sector to the private sector and other. The major flow of medium-to long-term funds is from SOCBs and the GDID to SOEs, and funds to domestic private companies are scarce.

Although credit to the state-owned enterprises has declined and there left room for credit to the non-state-owned sector, this share is still high compared with this sector’s share in GDP. One of the reasons is that SOEs have the advantage in using assets for loan collaterals. Moreover, ad hoc measures have currently been taken by the Government to help SOEs deal with difficulties. In general, the SOEs are more advantageous than the non-SOEs in accessing funds from the banking system. While the SOEs are financed by FDI and also hold a 50% share of credits, the contribution to GDP of SOEs sector (including the foreign direct investment enterprises) is about 50%. This reflects an unbalance of fund allocation between the SOEs and non-SOEs.

The demand for investment funds of the private sector is mostly funds for start up of their new establishments. In addition, demand for funds to modernize machines and upgrade production base also hold a high share. Although credit to the private sector has been expanded, difficulties in accessing credit from the banking system is one of obstacles to this sector's development because credit to the private sector is mainly to farm households and very little to production enterprises.

Capital shortage is a character of the private sector, both in rural and urban area. Approximately 25% of households, 32% of private enterprises and 32.5% of limited liability and shareholding companies in total 500 enterprises surveyed by Ministry of Planning and Investment stated that capital shortage is a big obstacle to their development. Capitals of the non-state enterprises come mainly from their own capital while credits from banks accounted only for small proportion (Table 16). Private companies do not have enough access to formal investment finance and rely on such sources as rollover of short-term loans and borrowings from relatives and acquaintances. Therefore, in many cases private companies do not have any other choice but to postpone investment projects.

Borrowings from professional moneylenders are also a common practice among private companies and proprietors. However, these are generally in small amounts and, aside from bearing high rates of interest, are only for the short term and accordingly are not suitable as investment funds. The reasons are considered to be from both side of private enterprises and banks' lending customs and relevant regulations.

As for the banks, they keep prudent attitudes toward private sector due to the reasons including of high risk, lack of government bailout. Regarding foreign bank branches, loans provided are concentrated in foreign direct investment enterprises.

Regarding the concerned regulations, according to current credit rules, loans cannot be provided without pledges or mortgage from the borrowers. However, there have been left many difficulties for private sector in the current situation related to land use right and other collateral¹⁰. Contrarily, the SOEs have no longer been required to provide collateral for their loans according to recent government's ad hoc measures.

From the enterprise's side, most private enterprises have small capital and low credibility as compared to that of the state-owned enterprises. In some cases the private enterprises do not have sufficient legal documents or lack ability in filing business plan for loans. In other cases borrowing from banks are hesitated by the owners, who don't want to provide reports on financial situation of the company. Additionally, lack of an accounting standard and low confidential level of reports are also the reasons that make banks hesitate to expand credit to non-state enterprises. Furthermore, complicated procedures and high transaction costs also make loans to the private sector less desirable from bank's point of view because a small loan

¹⁰ See Nguyen Thi Hong, "Flow of Funds between the Banking System and Enterprises in Viet Nam" in Study on the Economic Development Policy in the Transition toward a Market-Oriented Economy in the Socialist Republic of Viet Nam, Phase 3, MPI & JICA, 2001

required the same procedures as a big loan. To see the problem from other aspects, there are many corruptions in lending to small and private borrowers that occurred from these cumbersome procedures. In many cases, small and private borrowers have to pay high kickbacks of 6.5% or above to the “brokers” in order to obtain loans from banks¹¹.

In this light it is rather preferable to improve the transparency of banking manners through privatization and allowing foreign ownership.

The Issue of Non-Performing Loans

Bad debts in Vietnamese banking system are classified into 3 main categories as described in Table Regulations.

By the end of 1997, the ratio of bad debts compared with the total credit balance reached 12.3% and increased to 13.1% by the end of 1998, 13.7% by the end of 1999. This dangerous financial situation is attached with risks in potentially fast increasing exchange rate because from one third to 40% of the total bank loans are foreign currency-based, while most enterprises only have income in local currency obtained by selling goods imported by the above mentioned loans in the domestic market. The risk in payment also increases because the total capital mobilized by the banks keeps constantly higher than the lending capital, reaching 112% by the end of 1997, equal to that of crisis-hit countries in the East Asian countries. However, according to official report, the financial situation of the banking system in June 1998 was still rather low compared with the assessment of many economic specialists. Particularly, international auditing companies insisted that the total value of non-profitable loans of Vietnam is much higher than the official figure announced by the State.

By June 1998, the arrears compared with the total outstanding loans of state-owned banks were only 9.4% while this ratio of domestic joint stock banks reached 16.6%. Furthermore, about 58% of the total arrears of the banking system is considered hardly recoverable, even unrecoverable. Regarding this criterion, the state bank sector seems to be weaker than the non-state banks. (Table 17)

Another significant point is that the arrears and bad debts of Agribank are much less than that of others (Table 3, 17), which implicates a high quality loans in agricultural sector.

Besides the banks, people’s credit funds’ activities are not always safe and frequently encountering with problems at different serious levels in different periods. In early 1990, there were about 470 people credit funds in the whole country, mobilizing the total capital of as high as 21.7 times the registered capital. 90% of the mobilized funds was short-term capital and at a very high mobilizing interest rate, at the same time using 93.8% of the total capital for lending, resulting in 73% of the debts overdue. As a result, from mid 1990 to the end of the year, 100% of the lending capital became overdue and mostly all people credit funds went bankrupt.

The recovery of the people credit fund system went cautiously in the 90th decade along with the promulgation of regulations to control it. By February 1999, there

¹¹ See “*Thoi bao kinh te Viet Nam*” (Vietnam economic times), 18 November 2002.

were 975 people credit funds all over the country operating in 53 of 61 provinces. Although the crisis threat in this system is not very high, in about 5 years from 1996 to 2000, there were several negative signs in the activities of the system, leading to increasingly worsened financial situation. By February 1999, in People credit fund basis, arrears accounted for 4.2% of the total credit debt balance; financial balance of People Credit fund basis is low; about 30% of the people credit fund basis could not cover the cost with the gain. By March 2000, the ratio of arrears to the total outstanding loans in the mountainous and midland area in the North was 2.1%, in Red River Delta was 4.2%, in the former... Total arrears to total outstanding loans ratio was 3.88%.

Interest Rate Policies for Improvement of Financial Intermediary Function

The financial restraint model of Hellman, Murdock & Stiglitz (2000, mentioned below as HMS) introduced above in section one seems particularly useful for examining the interest rate policy in Vietnam. It shows the possibility of achieving dynamic efficiency at the cost of static efficiency in the financial market. That is, by imposing various financial restraints, such as interest rate controls or entry restrictions, the government may be able to support the development of the financial sector and its functions more effectively when the economy is at an early stage of economic development. Financial restraints allow banks to earn rents (excess profits), which could be invested for expanding their financial networks with borrowing firms and depositors and strengthen their organizational capabilities. HMS describes the financial restraint model as dynamic policy regime, moving toward freer and more competitive financial markets.

This section reexamines the current interest rate policy and studies alternative interest rate policies as incentive measure for banks' prudent behaviors.

The current interest rate policy

One of the central features of the interest rate policy in Vietnam has been the existence of ceilings on loan interest rates. In many developing countries the imposition of ceilings on nominal interest rates results in negative real interest rates and the transfer of the wealth from depositors to borrowers (and to the government through inflation tax). This is because the ceilings on nominal interest rates were accompanied by inflation caused by monetary finance of fiscal deficits. In case of Vietnam, however, the effective control over budget deficits and the growth of domestic credit combined with the rapid monetization of the economy succeeded in stabilizing its inflation process. Thus, the ceilings on loan interest rates did not result in negative real interest rates. In fact, the real lending interest rates remained positive since 1993 and quite high for some periods. For example, the real short-term loan interest rate was around 1.8%, 0.7%, 2.0%, 0.5% and 0.8% at the end of the year from 1993 to 1998. Note that the real rate has been controlled in a narrow range between 0.5% and 0.8% since 1996.

The direct regulation on deposit interest rates was dropped in January 1996. It was

replaced by the regulation on the maximum spread between the average lending rate and the average deposit rates. Combined with the ceilings on lending rates, the regulation on the maximum spread effectively imposes minimum deposit rates, although deposit rates could be lower if lending rates were set lower than the ceiling rates. The real 3 month deposit interest rate was around 1.1%, 0.0%, 1.3%, 0.0%, 0.2% and 0.4% at the end of the year from 1993 to 1998. Its values were quite high for periods when inflations decelerated rapidly. Since 1996, the real deposit interest rate has been also controlled in a narrow range between 0.0% and 0.4%.

Both real lending interest rates and real deposit interest rates have been controlled in narrow ranges since 1996. This is partly because of the stability of inflation and partly because of the adjustment of nominal interest rates by the SBV. The SBV lowered the ceilings on lending rates when the inflation rate declined, and increased the ceilings when the inflation rate increased. The policy has had a stabilizing effect on the real interest rates.

However, the combination of the maximum lending rate and the minimum deposit rate caused a serious problem for the financial state of the joint stock banks. Even under normal business conditions, joint stock banks have to offer deposit interest rates higher than the rates of SOCBs, because an explicit deposit guarantee does not exist for joint stock banks. But they have to follow the lead of SOCBs when SOCBs cut the lending rates below the ceilings because of the competitive pressure. Thus the financial base of joint stock banks is weaker than SOCBs in terms of interest rates.

But the more serious problem is the fragility of the banking sector as a whole. If a joint stock bank gets into a liquidity problem for one reasons or another, there is a strong possibility that the bank is tempted to resolve its cash flow problem by attracting new depositors with the offer of a higher deposit interest rates, further eroding its own profit basis. If the number of such weak banks is not negligible, they could cause anxiety about the safety of the banking sector as a whole and eliminate the demand for deposits at good banks as well. This is a typical adverse selection problem.

The SBV states in its 1996 annual report that the combination of the maximum lending rate and the maximum interest rates spread gives greater flexibility to banks in determining both lending and deposit interest rates. But, from the viewpoint of the financial development, such a policy regime restricts the financial capability of banks (especially, joint stock banks) to earn rents necessary to expand their financial networks. Furthermore, it could drive weaker banks into increasingly deeper financial troubles when the enforceability of prudential regulations is limited.

Two quantitative regulations have further constrained banks from expanding their financial networks. The most powerful instrument is the credit ceiling imposed on each bank. This regulation was introduced in 1994 in order to control the growth of the aggregate domestic credit of the banking system and thereby the rate of inflation. To the extent that the regulation was binding, marginal profits for banks of finding new borrowers were small. This is especially true when it is costly for banks to evaluate the credit risks of new borrowers and when there is a strong demand for credit from their long-term borrowers.

The other is the prudential regulation over the maximum amount of mobilized funds, that is, banks should not mobilize more than 20 times of their registered capital plus reserves. The amount of capital and retained earnings of banks defined the limit to the growth of their deposits. Thus bank did not have strong incentive to develop its deposit base.

Taxes on banking activities also had negative effects on the expansion of financial networks. When the government abolished the turnover tax on banking activities from the beginning of 1996, it imposed instead the regulation on the maximum spread between lending rates and deposit rates in order to transfer the benefits of removing the turnover taxes to borrowers and depositors. There was little concern for the need of the financial sector to rebuild the information channels with firms and depositors. Furthermore, banks were not allowed to charge the provision for non-performing loans as expenses and the profit tax rate was as high as 50%.

In summary, the interest rate policy and other related policies do not take into account fully that the financial sector is in its early stage of development. It has not paid sufficient attention to the financial need of banks for rebuilding its networks with borrower firms and depositors. Also it has deterred the development of the banking sector by allowing weaker banks to compete with higher deposit rates at the cost of stability of the banking sector as a whole. However, an important change was introduced into the taxation policy since the beginning of 1999. Banks are now allowed to count the addition to the loan loss provisions as their expenses. The profit tax rate was reduced from 45% to 32%.

3. Actions Underway and Future Directions for the Improvement of the Financial Intermediary Functions

Actions underway

Vietnam has been implementing a strategy to reform the system of commercial banks in order to rehabilitate bank system's health with the aim of improving safety and efficiency of financial intermediation in the economy. The Government has also adopted a program to reform banking system in order to promote its development and stability in harmony with Vietnam's macroeconomic framework. The main focus of the reform is to curb the growth of bad debts and to ensure that commercial activities of the banking system will be conducted safely and efficiently. In order to reduce financial systematic risks, it is necessary to encourage non-banking system while diversify channels of mobilization of savings, medium and long-term financial instruments.

The reform will be implemented alongside the SOEs reform. The reform of state-owned commercial banks is aimed at reinforcing management responsibility, initiative, and capacity to generate profits and to commercialize their activities. In the reform framework, debt administration and asset management companies (AMC) will be established to address bad debts. The debt resolution will include lending reduction and debt clearance for SOEs that are disbanded, leased, and equitized according to the SOEs reform.

Also, in this reform, the addition of supplemental funds to state-owned commercial banks on a 3-year basis will be implemented according to progress made in meeting the conditions, which is defined for every state-owned commercial bank, regarding the outcome of the comprehensive organizational restructuring and regarding the results of their progress in reducing the level of non-performing loans annually. The State Bank will strengthen regulatory framework, inspection and supervision of all banks and also will strengthen the regulatory framework regarding the rights of lenders, especially the right to impound assets used as collateral, to put these assets up for sale in the market, and the transfer of land use rights. The State Bank will put together the necessary policies and procedures to carry out bank inspections based on risks assessment.

Vietnam will continue to restructure and strengthen the joint-stock commercial bank sector. The State Bank has completed the financial assessment of joint-stock commercial banks and approved the plan to restructure this sector. Weak joint-stock commercial banks will have their licenses withdrawn or will be merged with other banks. The State Bank will continue to improve the legal framework with a view to creating favorable conditions for the expansion and development of joint-stock commercial bank activities on the basis of equal competition and respect for the law. Complete the reorganization and consolidation of joint stock banks in accordance with the approved plan, and at the same time impose strict penalties on banks that violate the law.

It is also a need to create a favorable and stable environment for credit and micro finance operations to help the rural finance system work with flexibility and in such a way that can most meet the poor's needs. It is as well required to reform and renovate the rural credit and finance systems, diversify credit instruments to make them more attractive to private investment in agricultural product manufacturing and processing.

Actions already underway that are assisted by international organizations are as below.

For the overall banking system

The overall restructuring framework, adopted in March 2001, lays out the broad principles guiding individual SOCB reform plans. The framework contains the following key elements aimed at improving management and operations of the SOCBs:

Increased transparency to assess the true size of NPLs: Decision 284 will be amended by end 2001 to move *loan classification* to international standards. In the meantime, each SOCB will undertake independent external IAS audits to assess NPLs at end 2000 and provide a basis for measuring and tracking financial performance.

Phase recapitalization of each SOCB over a three-year period: SOCBs will receive annual tranches of government funds for recapitalization, but only after implementing specified reform measures and meeting bank specific financial targets as agreed on an annual basis in an explicit understanding with the SBV.

A phase-out of policy and noncommercial directed lending: Such lending by the SOCBs will be eliminated except under limited and specifically identified

circumstances with explicit government guarantees.

Moreover, the SBV's restructuring framework stipulates general principles for NPL resolution through bank-specific *asset management companies (AMC) and loan-workout units (LWU)*. Those have been developed further and adopted by the government in October 2001 as follows:

Guidelines for resolution of nonperforming loans provide for specific mechanisms and procedures. The guidelines aim to induce each SOCB to make a serious effort at recovering loan values and take measures to reduce the flow of bad loans. Key prescriptions in this context include creating a separate asset management company (AMC) to resolve collateralized NPLs and loan workout units (LWU) for unsecured NPLs and providing debt restructuring for defaulting SOEs only if an approved SOE restructuring plan is in place.. This is because the task of resolving secured versus unsecured loans requires distinct expertise (asset valuation and disposal versus assessment of restructuring plans). Moreover, the expertise of LWU to enforce debts workouts and avoid recurrent NPLs should become an integral part of sound banking operations.

For individual SOCBs

Consistent with the overall reform framework, the four large SOCBs have adopted individual restructuring plans with bank specific reform measures and performance targets and an outline of bank specific mechanisms for bad debt resolution. For example, the Vietcombank restructuring plan, adopted in March 2001, provides for:

Performance targets and reform measures: Specific targets include a capital-asset ratio of 6 to 8 percent, a return on assets of at least 0.5 percent, and NPLs below 4 percent of total loans outstanding by the end of the three-year-restructuring period. Operational measures are expected to strengthen risk management and decision-making.

Procedures for NPL resolution: Operational measures include completion of (1) a loan classification for all loans and recovery action plans for bad loans to the 50 largest debtors in the first year, and (2) recovery plans for bad loans to the remaining debtors by 2002. The NPL recovery rate for the LWU is tentatively targeted at 10 percent in 2001, rising to 25 percent by 2002, and 35 percent by 2003. Over the three-year restructuring period, provisions based on IAS will be phased in accordingly.

Moreover, the SOCBs are subject to an SBV directive containing bank specific milestones for loan restructuring and operational targets. This directive governs the minimum conditions in the form of quarterly milestones for a phased recapitalization of each of these SOCBs. In order to commit SOCBs to meaningful recovery efforts and avoid the resurgence of new bad loans, the milestones include:

Quantitative debt resolution targets: By-end March 2002 the four large SOCBs as a group are required to resolve at least *D 1.4 trillion, equivalent to about 10 percent of recoverable NPLs*. Resolution targets for later test dates are expected to be agreed once the results from IAS audits of the 2000 financial statements become available, and will also be set on the basis of revised classification on international accounting standards.

Operational targets: The SOCBs are required to establish by end-March 2002

credit risk management and internal audit committees; by end-June 2002, to agree on qualifications from the 200 IAS audit that are to be eliminated by end-2002 and sign contracts for the external IAS audits for the year 2002; by end-September 2002, to pass special SBV examination of credit file documentations; and by end-December 2002, to complete the 2001 external audits without qualifications as agreed in June 2002.

It is understood that future milestones would be specified on the basis of experience with the implementation of earlier milestones and developments in SOCB conditions.

For JSBs

The banking system includes 48 JSBs, which are privately owned and typically operate on a limited local scale. By end-2000, the State Bank of Vietnam (SBV) had completed the financial assessment of these banks and *placed 13 banks under special supervision, with two licenses revoked and one bank merged*. In the first half of 2001, *licenses of four additional problem banks were withdrawn and one bank was taken over by Vietcombank*.

Improvements in legal and regulatory framework

Improvements in the legal framework aim at increased transparency and efficiency of the banking sector, promoting the resolution of bad debt, and enhancing prudential supervision. In this context, *loan classification* is to be brought closer to international standards (in particular to classify entire loan values rather than only the overdue installments as nonperforming), and *loan provisioning* will be phased in over a three-year period.

Technical assistance is being provided by the World Bank in addressing impediments in the legal framework to the resolution of bad debt and disposal of collateral, including strengthening of creditor rights to facilitate foreclosure and liquidation of assets. This will help enhance the effectiveness of AMC's and LWU's in their loan recovery efforts.

Moreover, the SBV issued in September 2001 a decree establishing a deposit insurance scheme that helped to level the playing field in the mobilization of dong for JSBs, foreign bank branches and SOCBs. Remaining restrictions on foreign banks are expected to be relaxed gradually¹².

Improvements in prudential supervision are expected to include adoption of a risk-based approach to banking supervision, and reinforcement of on-site inspection and off-site supervision. Relevant capacities and skills are expected to be strengthened through training programs and the development of new manuals for supervision. In this context, banks have begun to work closely with foreign bank branches in such areas as payments systems and internal audit procedures. This cooperation could also lead to twinning arrangements over the medium to long-term.

¹² Major impediments on foreign banks include regulations: prohibiting the intake of foreign currency deposits from households, limiting the intake of dong deposits from households or economic entities (that are not borrowers) to 25% of bank capital.

Further Measures Needed to Resolve Current Problems in Banks

Issues on Corporate Governance, Ownership and Banking System Design

Effective Corporate Governance Structure

Theoretical and empirical studies suggest that stock and bond markets are not going to play a major role in the provision of funds during early phases of economic transition. Promoting the liquidity of stock and bond markets is of second order compared with the promotion of liquidity in markets for real assets. Raising funds through minority equity is likely to be particularly difficult given the strong insider control and poor protection of minority interests, what are serious problems that transforming economies in general and Vietnam in particular are embracing. Further, bank-oriented intermediaries will use both debt and equity monitoring. Debt and equity control complement each other. However, given the nature of the corporate governance problem with severe agency problems in poorly performing firms and the need for drastic restructurings, the kind of control exercised through debt holdings is likely to be particularly important. The scarcity of monitoring resources also suggests some that state-contingent monitoring will dominate. Moreover, both mutual funds and commercial banks will be needed, but banks are likely to be more important in corporate governance. Given the need for debt monitoring, commercial banks tend to be better in playing the main role and their ability to provide several kinds of finance may prove valuable.

In this context that it is the utmost important issue for Vietnam both in short in long term to increase the screening ability of the banking sector. This includes many issues in which developing small and medium business sector and allowing more active participation of foreign banks will be of extremely great importance. The facts that much of the funds mobilized from domestic savings are flowing into the government sector in the form of purchases of government debt, and that current bank transactions are dominated by the 4 state banks... are indicative of the as yet underdeveloped state of financial intermediaries with respect to the market mechanism. Given the situation in the banking sector in present day in Vietnam, the challenge of securing the viability of the small and medium business sector will be considerable. The latter issue of more roles for foreign banks on the other hand, will be discussed below.

Equity markets may gradually come to play a role in facilitating ownership transfer, and ultimately also in generating information about the performance of companies in a long-term view, but not in the short period. In summary, relying on a bank-oriented financial system to promote economic growth may be the tendency for Vietnamese economy at least at early stage of development. The issue then comes to be, what form of a system would present an effective corporate control mechanism, which can overcome the agency problems in the situation of severe information asymmetries in Vietnam? The answer is quite not simple. Even the core issue whether the main bank

system' monitoring mechanism where private main banks play centered role with supervision and convoy of the authorities was effective in Japan, remains controversial. Furthermore, the institutional ability of Vietnam is considered to be far more inferior compared with that of Japan in high growth period, the fact that further exacerbate the problem of who monitors the monitors.

Ownership Structures of Banks:

The distressing experience of Asian crisis countries in previous years suggests the need to contemplate various options regarding effective ownership structures for banks in transitional economy of Vietnam. These include the choice between state and private ownership, cross-holding (or interlocking) ownership structure and widely dispersed one, between domestic and foreign ownership.

State ownership in banking continues to be popular in many countries for several reasons. These include assertions of proponents of state control arguing that the government can do a better job in allocating capital to highly productive investments. There is also the concern that, with private ownership, excessive concentration in banking may lead to limited access to credit by many parts of society. However, there are quantitative studies that suggest discouraging evidences against the state ownership. Government failure as owner is attributed to the incentives imposed on it by the political process. Greater state ownership of banks tends to be associated with higher interest rate spreads, less private credit, and less non-bank credit. The few cases of more successful state banks appear to be linked to a stronger institutional environment and dispersed political powers. Privatization can lead to a more efficient banking sector, but the process should be handled with care. Quantitative researches also suggest the case that shifting to private ownership in a weak regulatory environment can lead to crisis. A sudden move to private ownership from a lengthy period of state ownership seems particularly dangerous. Accordingly, moving deliberately but carefully with bank privatization, while preparing state banks for sale and addressing weaknesses in the overall incentive environment, would appear to be preferred strategy. Many countries reached an advanced stage of development with modest state ownership.

Regarding the second choice between interlocking and widely dispersed ownership of banks, the experience of Asian neighboring countries suggests that this remains a controversial issue. The former may help to reduce agency problems of debt finance, but might lead controlling owners to expropriate other investors and stakeholders and pursue personal non-profit maximizing objectives as well, as the case of Asian crisis-attacked economies' experience implied. On the other hand, the latter is not quite a solution as well because it may not provide effective oversight to banks until enforcement of prudential regulations is adequate. Hence selling off intervened bank shares fully to the public also may not be a viable option for the privatization effort. Another option is to sell shares widely to the public but also encourage fee-based representation of the dispersed owners to oversee bank management. Firms with banking experience would represent the public in this process. Some studies suggest that, holdings of debt and equity will tend to be concentrated, with little turnover in

control blocks. The corollary of illiquid stock and bond markets is highly concentrated and stable ownership structures. Patterns of ownership and control established at early stages of transition are likely to persist over long periods of time¹³.

While the above issue remains unclear, the reliance on foreign ownership seems to have much to recommend. Allowing entry of more foreign financial institutions is a policy option to improve efficiency and raise the international competitiveness of Vietnamese financial institutions. A level playing field should be established between SOCBs and non-state-owned banks. As yet, foreign financial institutions have played a limited role in training, and there is scope for them to take on a much greater role in this area with an expanded presence. If foreign banks are given favorable conditions for establishing joint-venture banks with Vietnamese bankers and allowed to be engaged in full-time business equivalent to those of domestic banks, their incentives to commit themselves to domestic financing will be substantially increased. They can bring in sorely needed expertise and generate demonstration effects. The Vietnamese banks will need long time to improve their abilities in monitoring and intermediating. Until then, banking sector should increase dependence on foreign banks in order to keep stability in the financial system¹⁴. However, there are some obstacles to a larger presence of foreign financial institutions such as the lack of transparency and the restrictions on taking dong deposits.

On the other hand, too rapid entry of foreign financial institutions may pose too severe a competitive threat to domestic financial institutions and undermine financial stability. Policy on entry of foreign institutions should be designed to ensure that it occurs in a controlled manner.

Role of government in financial institutions

Under the situation of severe information asymmetries, information on bank activities is incomplete and not entirely accessible, particularly for small non-institutional savers. Monitoring by depositors cannot be relied upon completely to discourage irresponsible behavior on the part of banks, so a case can be made for government regulators to impose restrictions on them. These restrictions might take the form of limiting the amounts of risky assets that banks can hold, and requiring banks to diversify their assets. An other possible restriction would require banks to have a higher level of equity capital relative to assets deposits, as a cushion against bad loans and so that bank owners would have more to lose if their banks failed¹⁵.

Universal deposit guarantees by the government tend to lessen the incentive for depositors to monitor and discipline their banks, and are therefore not recommended, since this can result in reckless behavior on the part of bank management. A more effective approach would be for the government to lift restrictions on foreign joint venture banks, and allow them to take deposits from local residents, so as to provide competition for local banks.

Just as governments have hold determinant role in shaping financial system in

¹³ See Erik Berglöf Aoki and Kim et al. (1995)

¹⁴ Horiuchi, 1998

¹⁵ Le Dang Doanh in McLeod and Garnaut et al. (1998)

many countries, more role of the government would be expected for shaping an effective corporate control mechanism as well as developing the infrastructure of the Vietnamese financial system. These roles in concrete form will be discussed further below from the aspects of prudential regulations and interest rate instruments.

System of commercial banks and long-term

In developing countries like Vietnam, it is thought that most savers desire to hold their savings in the form of liquid and short-term assets such as short-term bank deposits. On the other hand, enterprises must invest in equipment and factories with long periods. Thus, early stage economic development requires a rather extreme degree of maturity-transformation. A system in which credit banks working together with long-term credit banks may function well in creating long-term finance for industrializations. Therefore, introduction of a system of long-term credit banks where commercial banks with liabilities of short-term deposits will cooperate with a few long-term credit banks, which specialize in long-term credit and issue bank debentures with longer maturities than those of deposits, seems to be an effective direction for Vietnam. Such a system will be able to mitigate the limitation on maturity-transformation in the banking sector.

Building up a sort of syndicated loan system centered on the most reliable bank, which has accumulated expertise in inspecting investment projects, will be instrumental in economizing the capacity of information production in the banking sector. Under this system, a core bank, say BIDV, is responsible for examining and monitoring borrower enterprises, but the bank provides only part of the total loans to a specific borrower. The remainder is supplied by other commercial banks, which are allowed to free ride on the core bank's information production via examining and monitoring. This system will to some extent economize on financial intermediation capabilities in the immature banking sector.

Development of capital market for complementing banking system:

Since Vietnam is a transition economy, the market-oriented banking system itself has had a very short history of development and capital markets need to be established from scratch. Moreover, because of Vietnam's heritage of planned economy, the general public is not familiar with securities markets, and there is a huge need to educate them.

It seems reasonable to put priority on development of the banking system in the short run and to correct the bias by developing capital markets in the long run. Moreover, as inward portfolio investment adds to volatility of international capital flow, inward portfolio investment as a way of developing domestic capital markets should be handled with great care. It may be reasonable to allow closed-end mutual funds to invest in domestic securities in the beginning to avoid the negative impact of the volatility of international capital flow.

Vietnam needs to develop stock markets in order to absorb the stocks that will be issued for equitization of SOEs. Equitization is also absolutely necessary in order to establish the health of the banking system, which is the utmost priority. Since there

are very few large firms eligible for listing in stock exchanges in Vietnam, the stock markets will be very different from those in more advanced economies. It seems reasonable to expect that the stocks of most SOEs are not very attractive investment vehicles, as their operating efficiency is rather low and their size is small. Thus, Vietnamese stock markets will probably focus on relatively large and stable utility-type firms, which have investment value because of their natural monopoly position.

There are also obstacles to the development of bond markets. It is rightly recognized that bond markets should be developed initially by focusing on government bonds. One-year government bonds were issued under private placement. The Ministry of Finance is said to contribute to the development of bond markets in Vietnam. With regard to corporate bonds, large utilities can be candidates for issuers in the initial period. Preferential loans to SOEs are said to restrict the development of corporate bond markets by lowering the incentive for these firms to issue bonds. The policy option of leveling the playing field for competition between loan financing and bond financing requires the termination or restriction of preferential lending to SOEs.

The development of infrastructure for securities trading is a daunting task. Establishment of securities trading centers faces difficulties in securing capital, technologies, know-how, and trained professional staff. The preparation of securities laws with foreign assistance is probably easier, but it will be a major challenge to establish supervisory agencies staffed with trained personnel to enforce. It is also difficult to establish enough securities trading firms with sufficient expertise. Foreign assistance may play a role in these areas.

Conclusion Remarks

Vietnam's financial system faces the intertwined problems of instability and inefficiency. Inefficiency is due to the problems commonly seen in the low developed market economies. Regarding the banking sector, these problems include poor capital and reserves, low level of management, improper accounting practices, lack of transparency and furthermore, the excessive intervention of the government. Bond and securities market is still on its infant period and its functioning of intermediary role is extremely limited, as discussed in section one of the paper. The inefficiency is furthermore accelerated by discouraging banking policies inclusive of policies concerning interest rate and tax that leaves banks least margin to afford their infrastructural or technological improvement. Policies concerning privileges on behalf of the state-own sector are discouraging either.

Section two of the paper illustrated the facts that these bad practices necessarily lead to moral hazards in the financial activities that in turn result in the low mobilization of domestic funds, failures to fulfill the long-term capital demand for industrialization for private enterprises in spite of the growing importance of this sector; above all, huge amount of non-performing loans that cost vastly to be resolved manifests the prolonged bad lending practice in banking sectors. This section strongly suggested that along with the human resource as the basic factor behind the current problems, it is systematic issues inclusive of corporate governance, ownership structure and financial system design that do matter.

In light of these theoretical issues, section three tries to shed a light on directions for improving the performance of financial intermediaries in the country. In addition to the uncontroversial needs of sufficient legal and regulatory frameworks, adoption of international laws and practices, improvement of supervision bodies, enforcement and disclosure, and the need of auditing and accounting reform, this paper strongly suggests for introduction of incentive measures for banks including of tax concessions and interest rate policies. Incentives by these means should be considered to encourage financial institutions to set aside a greater proportion of their profits to develop their infrastructure. This will lead not only to higher mobilization of domestic savings, but also to the more efficiency of the overall financial operations.

Regarding structural issues of corporate governance and ownership, the paper tried to allege that, while private ownership, free foreign ownership and excessive competition in a weak regulatory environment may lead to crisis and undermine the financial stability, the gradual privatization of current state-owned commercial banks and appropriate introduction of foreign ownership seem to be inevitable direction for recent future. Role of commercial and long-term credit banks working in tandem with each other as well as the utmost importance of long-term developing capital markets also were affirmed in section three.

There must be other problems existing in the current financial intermediaries that this paper failed to deal with due to lack of statistics. I wish to further contemplate these in following studies.

References

- Aoki, M., and H. K. Kim. (eds) (1995) *Corporate Governance in Transitional Economies* Washington D.C.: The International Bank for Reconstruction and Development, The World Bank.
- Bank for Investment and Development. *Annual Report 1999*. Hanoi.
- Cac Van Ban Phap Luat Hien Hanh (Current Law Documents on Banks)*. 2000. Hanoi: The Statistical Publishing House
- Dewatripont, M., and J. Tirole. (1994) *The Prudential Regulation of Banks* Cambridge, MA: MIT Press.
- Diamond, D. W. (1984) "Financial Intermediation and Delegated Monitoring" *Review of Economic Studies*, LI, 393-414.
- Follow-up Study for the Economic Development Policy in the Transition toward a Market-oriented Economy in Vietnam, Phase 2, Vol. 2*. (1999). Tokyo: Japan International Cooperation Agency.
- General Statistical Office. (2001). *Statistical Yearbook 2001*. Hanoi: Statistical Publishing House.
- Hellman, T. F., K. C. Murdock, and J. E. Stiglitz (2000) "Liberalization, Moral

- Hazard in Banking, and Prudential Regulation: Are Capital Requirements Enough?" *The American Economic Review*, 90(1), March, 147-65.
- Hermes, N. and R. Lensink (1996) *Financial Development and Economic Growth* New York: Routledge Press.
- Horiuchi, A. (2000). "Japan's bank crisis and the issue of governance." In P. Drydale (eds.), *Reform and Recovery in East Asia – The role of the state and economic enterprise*. New York: Routledge Press.
- International Bank for Reconstruction and Development. (2001). *Finance for Growth-Policy Choices in A Volatile World*. Washington, D.C.: A World Bank Policy Research Report, The World Bank.
- International Bank for Reconstruction and Development. (1998). *East Asia: The Road to Recovery*. Washington, D.C.: The World Bank.
- International Bank for Reconstruction and Development. (2000). *East Asia: Recovery and Beyond*. Washington, D.C.: The World Bank.
- Institute for Development Strategies. *Trien vong kinh te Viet Nam (Prospects of the Economy of Vietnam)*. 2002. Hanoi.
- International Monetary Fund. (2002) IMF Country Report No. 02/151, No. 02/4. Washington D.C.
- Social Republic of Vietnam. (2002) *The Comprehensive Poverty Reduction and Growth Strategy*. Hanoi.
- Ishikawa, S., and Hara, Y. (eds.) (1999) *Vietnam no Shijyo Keizaika (Transition toward Market-Oriented Economy)* Tokyo: Toyo Keizai Shimposha
- Ishida, A. (eds) (2002) *2001nen Totaikago no Vietnam, Laos – Aratana Kadai eno Chyosen (Vietnam and Laos after the Communist Party Congress in 2001: New challenges)* Tokyo: Institute of Developing Economies.
- Kunimune, K. (eds) (2001) *Asia shyokoku no Kinyukaikaku no Romten (Financial Reforms in Asian countries)* Tokyo: Institute of Developing Economies.
- Mayer, C. (1988). "New Issues in Corporate Finance." *European Economic Review* 32, 1167-88.
- Mayer, C., and V. Xavier. (Eds., 1993). *Capital Markets and Financial Intermediation*. Cambridge: Centre for Economic Policy Research, Cambridge University.
- McLeod, R. H. and R. Garnaut. (eds., 1998). *East Asia in Crisis*. New York: Routledge Press.
- OECD Research Papers No.9. (1996). *Fiscal and Financial Reforms in Vietnam*. Tokyo: The Research Institute of Development Assistance.
- Okuda, H. (2000) *ASEAN no Kinyu System – Chyokusetsu Toshi to Kaihatsu Kinyu (Financial Systems of ASEAN – Foreign Direct Investment and Development Finance)* Tokyo: Toyokeizai Shimposha
- Study on Economic Development Policy in the Transition Toward a Market-oriented Economy in Vietnam, Phase 2. Vol. 3. 1998. Tokyo: Japan International Cooperation Agency.*
- Study on Economic Development Policy in the Transition Toward a Market-oriented Economy in the Socialist Republic of Vietnam, Phase 3. Vol. 3. 2001. Tokyo: Japan*

- International Cooperation Agency.
- State Bank of Vietnam. Annual Report 1999, 2000. Hanoi.
- Takasaka, A., and Ohno, K., (eds) (2002) *Aratana Kaihatsu Senryaku wo motomete (In search of new development strategies)* Tokyo: Institute of Developing Economies
- Takeuchi, I., and Murano, T. (eds) (1996) *Vietnam no Shijyo Keizaika to Keizai Kaihatsu (Transition toward Market-based Economy and Economic Development in Vietnam)* Tokyo: Institute of Developing Economies
- Tran, Kim Hao. (1996) "The Informal Forms of Financial Mobilization and Development of the Small and Medium Enterprises", *Viet Nam's Socio-Economic Development*. Hanoi
- Watanabe, S. (2000) "Vietnam Ni Okeru Fuyousaikenmondai – Ad hoc na Sochi to Kozokaikaku" (The Problem of Non-Performing Loans in Vietnam – Ad hoc Measures and Structural Reform). In *Kinyu to kigyō no Saikouchiku (Restructuring of Finance and Enterprises)* Tokyo: Institute of Developing Economies
- Zhuang, J., D. Edwards, and M. V. Capulong ed. (2001). *Corporate Governance and Finance in East Asia*. Vo. 2. Manila: The Asian Development Bank.
- Vietnam Economic Times. *Kinh te Viet Nam 1998-1999, 1999-2000, 2000-2001, 2001-2002, Viet Nam & The Gioi (Domestic and International Economies 1998-1999, 1999-2000, 2000-2001, 2001-2002)*. Hanoi.
- Ministry of Planning and Investment. *Vietnam Investment Review* No. 548, 680, 798, 900, 940
- Ministry of Justice. (2002) Vietnam Law Database CD-ROM, Version 3.
<http://www.vietlaw.gov.vn>
<http://www.vir.com.vn/>
<http://www.vneconomy.com.vn>